Bin Yuan Capital - July 2017

Performance Snapshot and Market Update

Chinese stocks extended their rally in July, with both the Shanghai Composite Index and Hang Seng China Enterprise Index closing at their highest level in more than a year, driven by expectations of an improving economy. Shanghai Composite Index was up 2.52% and Hang Seng China Enterprise Index jumped 4.46% in July.

China's economy generally maintained its momentum in July 2017. The producer price index (PPI) rose 5.5% year on year (YoY) in July, unchanged from that registered in June and May. The consumer price index (CPI) edged down 0.1 percentage point, rising 1.4% YoY. The official manufacturing Purchasing Managers' Index (PMI) eased to 51.4 in July from 51.7 in June and the official non-manufacturing PMI in July was also down to 54.5 from 54.9 in May. But both manufacturing and non-manufacturing PMI was still well above the expansion/contraction threshold of 50. Rail cargo volume grew 16.4% YoY in June to reach about 299 million tons, marking the eleventh consecutive YoY monthly rise.

In the first half of 2017, major industrial firms reported profits of RMB3.63 trillion, a 22% increase from the same period last year, far exceeding the 8.5% increase in 2016. The better than expected economy was partly resulting from the market-driven supply-side consolidation. This leaves enough room for the government to continue to push structural reforms and curb financial risks in the second half of 2017, which will contribute to the long-term health of the economy.

In order to protect investors' interests, the China Securities Regulatory Commission ("CSRC") strengthened its supervision and punishment on illegal market activities in the first half of 2017. During the period, CSRC gave fines of RMB6.4 billion and dealt with 24 cases of violations in information disclosure, 24 cases of insider trading, and 14 cases of market manipulation. The number of cases increased dramatically as compared to the same period last year.

After the successful launch of stock trading links between China (Shanghai and Shenzhen) and Hong Kong in the past two years, the Chinese mainland's Bond Connect arrangement with Hong Kong opened on 3 July 2017. The Bond Connect arrangement allowed only international and Hong Kong investors to trade onshore bonds in the initial phase. This was another signal of the country's continuous effort to open its securities market and might pave the way for the world's third-largest debt market to be included in global indexes. On the one hand, the Bond Connect can bring more capital into China and on the other hand, it is also conductive to the internationalization of RMB.

Performance Attribution

In July, Consumer Staples and Information Technology were the top two contributors while Consumer Discretionary and Materials lagged.

At the stock level, a TMT company was the top performer primarily due to the continuous hit of its mobile game "The Honor of the King" and the success of the new game Tian Long Ba Bu. In addition to the mobile game segment, mobile payment is another highlighted business for the company which might start to contribute profit in this quarter. We believe the TMT company, whose traffic barrier is almost impossible to challenge currently, will continue to extend its dominant leadership in the Chinese internet industry.

An auto body part manufacturer underperformed in July primarily because some investors took profit after the stock price hike in previous months, which was partly due to its strong earnings growth for 2017. We believe the company will keep growing by expanding customer bases and lifting value of single car usage. In addition, the company will benefit from the trends of lighting weight and interactive network of vehicle, which will become its next growth drivers for the long term.

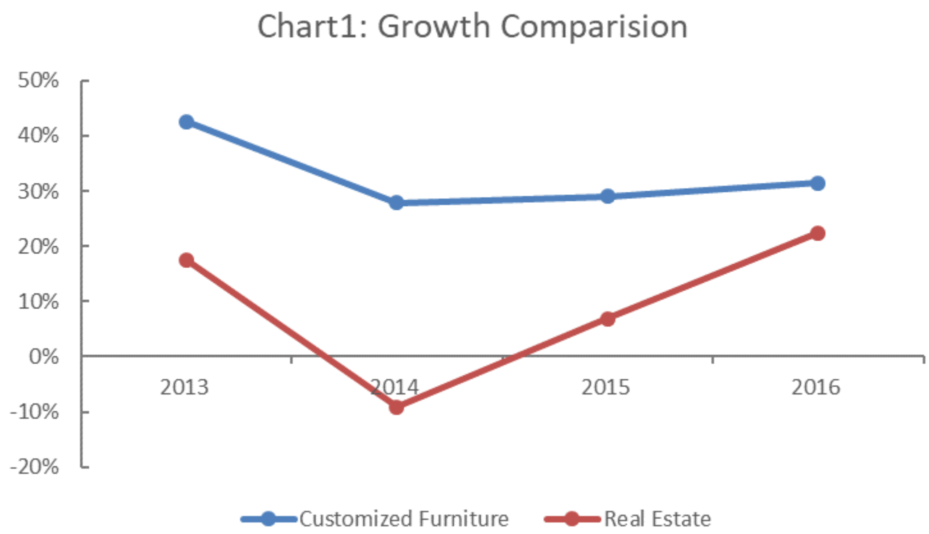
Local Insights and Portfolio Positioning

Household consumption is one of the biggest categories of spending among Chinese families. The total market size might achieve 4 to 5 trillion RMB. China economy will keep on growing and form the world’s largest population of middle class in the next ten years. With more disposable income in hands, expenditure on furniture will exceed RMB1,500 Billion, making China the world's largest furniture market. With such an enormous market size, China will at least have one or two world-class furniture companies, following the path of household appliance leaders, Midea and Gree. The consumption upgrade trend and rising requirement of efficiency will help the consolidation within the industry.

Consumption Upgrade Trend of Furniture Industry

- *Customization*

Over the past four years, the customized furniture industry grew rapidly and became the most promising niche market in the furniture industry. The sales growth rate was consistently above 25% despite the real estate’s downturn in 2014 and was much higher than the real estate growth due to the penetration increase of the customized furniture. (Chart 1)



Source: Wind

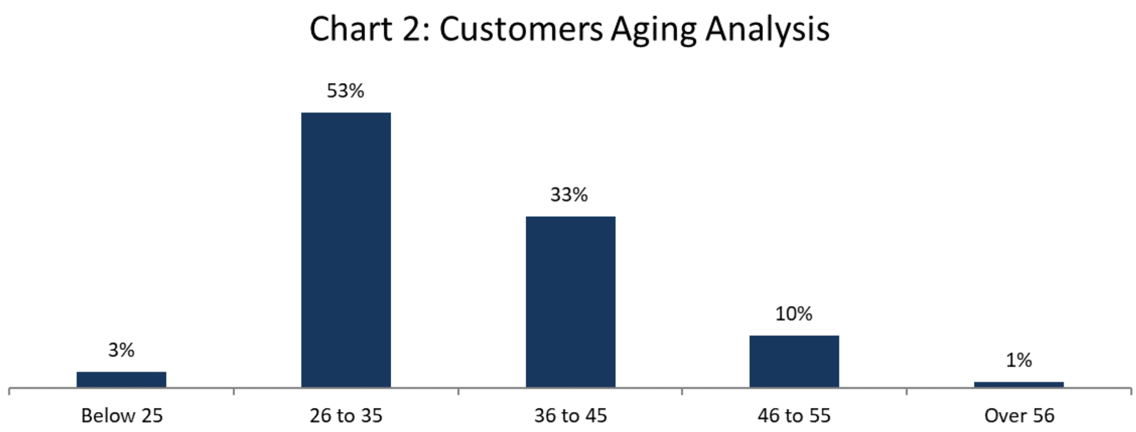
Looking into the future, we are still confident that the industry will attain a 15% growth for the next couple of years due to the following reasons:

1. The penetration rate of the customized furniture was only 30% for the wardrobe and 40% to 50% for the kitchen cabinet in 2016. We expect the final penetration rate can reach above 70% for both.

2. The price of customized furniture kept falling over the years due to economies of scale and the price became even lower than the traditional furniture.

3. China's young generation is more willing to purchase customized furniture than their parents due to young generation's preference for simple style. More than 50% of the customers are between 26 to 35 years old. Demography is favourable for the industry. (Chart 2)

4. Hiking house prices also stimulated consumers' needs to purchase customized furniture to better utilize the space.



- *Versatilities*

Sofa has long been a must furniture in Chinese households and it did not change much in the past. However, in recent years, large sofas with reclining backs became more and more popular. Lying on a reclining sofa, one can read a book or watch a movie or have a nap much more comfortably. In the past, the reclining sofa is much more expensive than the traditional sofa. However, with the increase of the disposable income of the Chinese people and the drop of the retail price due to economies of scale, the premium price was not the major concern for Chinese consumers. The penetration kept increasing in recent years but was still only slightly over 10% in China in 2016. While in the US, the penetration rate was 40%. Thus, there is still a lot of potential for the reclining sofa business in China.

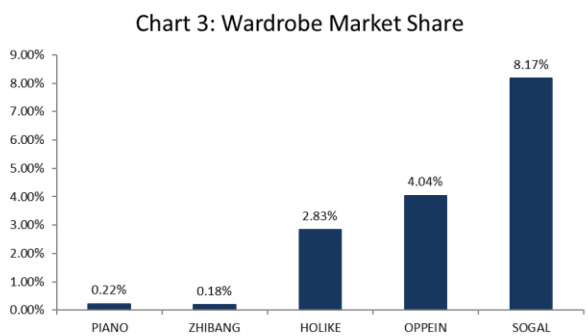
Efficiency Improvement

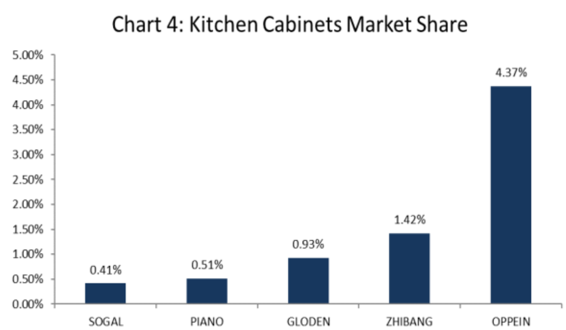
With a clear trend of consumption upgrade, the manufacture of furniture is also upgrading. In the past, the manufacturing process was relatively simple which mainly just included the assembly work. However, in order to meet consumers' more customized and functional demands of furniture, the manufacture will involve more value-added activities such as design, supply chain management for delivery, installation, etc. and the company needs to efficiently organize all the activities to improve the customer experience. The efficiency becomes one of the critical success factors for furniture companies.

SOGAL and OPPEIN are two top companies in the customized furniture industry and are leading in almost every aspect of the operation in their respective niche market. In the wardrobe market, SOGAL has the most extensive sales network and its sales per square meter reached RMB22,800 in 2016, 57% higher than OPPEIN. While in the kitchen cabinet market, OPPEIN is more dominant. Its stores are twice as many as ZHIBANG's and so are the sales per square meter. In the long run, we believe the market will continue to consolidate and the leading companies such as SOGAL and OPPEIN will take market shares due to their economies of scale, better operations of supply chain for delivery and branding effort, etc. For details, please refer to the table below and Chart 3 & 4.

	Wardrobe					Kitchen cabinets				
	SOGAL	**OPPEIN**	HOLIKE	PIANO	ZHIBANG	**OPPEIN**	ZHIBANG	GLODEN	PIANO	SCHMIDT
Number of Stores	**1,800**	**1,394**	1,200	290	153	**2,088**	1,112	764	591	500
Sales (mn RMB)	**4,110**	**2,022**	1,416	113	91	**4,369**	1,419	925	508	413
Square meters per store	**200**	**200**	200	200	200	**200**	200	200	200	200
Sales per store (KRMB)	**2,283**	**1,451**	1,180	388	596	**2,093**	1,276	1,211	860	826
Sales per sqm (KRMB)	**22.8**	**14.5**	11.8	3.9	6.0	**20.9**	12.8	12.1	8.6	8.3

Source: Wind/annual reports





While in the reclining sofa industry, Man Wah is the indisputable market leader and Man Wah's brand "CHEERS" is dominant in China with a 37.7% market share in 2016. Besides distributing its brand products in China, Man Wah also sells reclining sofas in the US mainly through OEM business. It accounted for a market share of 9.6% in the US in 2016. The company vertically integrated its supply chain and all the main functional components are made in-house with lots of know-how accumulated. This ensures Man Wah's excellent user experience and cost advantages over its competitors.

Conclusion

With Chinese consumers becoming increasingly sophisticated, they care more about the design/life-style, quality and brand instead of just the price when they choose household furniture. During this trend, we believe only those brand companies with innovative products and well-managed supply chains can meet the customers' upgrading demands. According to our assessment, Man Wah, OPPEIN, SOGAL and KUKA will be the potential winners in this industry.

Sincerely,

Bin Yuan Capital

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