Bin Yuan Capital – Third Quarter 2017

Market Review

The Chinese stocks were back on its growth trend in the third quarter with a more positive economic outlook. In Q3 2017, the Shanghai Composite Index was up 4.90% and Hang Seng China Enterprise Index performed even better by picking up 5.26%.

China's economy generally maintained its growth momentum in the third quarter of 2017. The official manufacturing Purchasing Managers' Index (PMI) rose steadily from 51.4 in July to 52.4 in September and the official non-manufacturing PMI was also up from 54.5 to 55.4 during the same period.

In Q3 2017, the depreciation expectations that had loomed since the exchange rate reform two years ago finally eased with stabilized expectations. After appreciating for more than 4% since the beginning of 2017, the RMB-Dollar exchange rate will probably realize two-way fluctuations in the rest of the year as too much appreciation will also hurt the economy. We believe the stable RMB contributed to the improvement of the earnings of corporates.

According to the interim report of A-share listed companies, most industries recorded positive net profit growth in the first half of 2017. Among all the companies, big enterprises with environmental facilities grew even faster than small and medium enterprises ("SMEs") because the strict environmental protection policies increased costs of SMEs. However, as the government's support measures for renewable energy companies were still pending, earnings of companies in new energy and utility was below expectation.

A targeted reserve requirement ratio (RRR) cut was announced by the People's Bank of China (PBOC) on the last day of September, which was the first time since February 2016. However, the timeline of policy change not effective until 2018 showed that PBOC would continue to manage the expectation of maintaining a prudent and tightened liquidity environment. We think that the improving efficiency of capital use is more important than the volume of liquidity, which were discussed in our newsletter of last quarter. In addition, we expect that the potential cost savings in areas such as taxes, finance expenses and logistics costs will be another driver for the growth of China's economy. Productivity improvement will be the focus.

China released a guideline that focused on encouraging entrepreneurial spirit in September. The guideline stressed that the government will protect the legal rights and interests of entrepreneurs, ensure fair competition and strengthen protection of intellectual property rights. The guideline showed that China will continue to create a favorable environment for entrepreneurship, which is expected to give a boost to the country's innovation-driven development.

Performance Attribution

During Q3 2017, our stock selection in Financials and Information Technology performed well while Consumer Discretionary names lagged. In addition, the relative underperformance of the A-share market and new energy and manufacturing companies also hurt our performance.

At the stock level, a social media name was the top performer primarily due to its strong Q2 result. Its game sector benefited from the continuous hit of Kings of Heros, which grew by 39% YoY. In addition, the advertising business reached over RMB10 billion for the first time with a 55% growth rate. 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.

A small cap auto part company with limited market coverage and liquidity underperformed in the third quarter. The company supplies plastic auto parts to auto OEMs. Through strong cost control, it delivered an over 50% earnings growth in the first half of 2017. We believe it will keep its high growth by expanding the customer base, and lifting per car usage of its products. The company also made some investment on new materials and new technology, which will become the next growth driver in the long-term. The company is trading at a 2017 PE of 8.5X.

China Outlook and Portfolio Positioning

In the newsletter of last quarter, we discussed the reasons why China growth story will continue even amid the circumstance of slower liquidity growth. The improving efficiency of capital use is more important than the volume of liquidity. In this newsletter, we apply an approach from cost perspective and focus on potential opportunities of cost reduction that could drive China growth in the future.

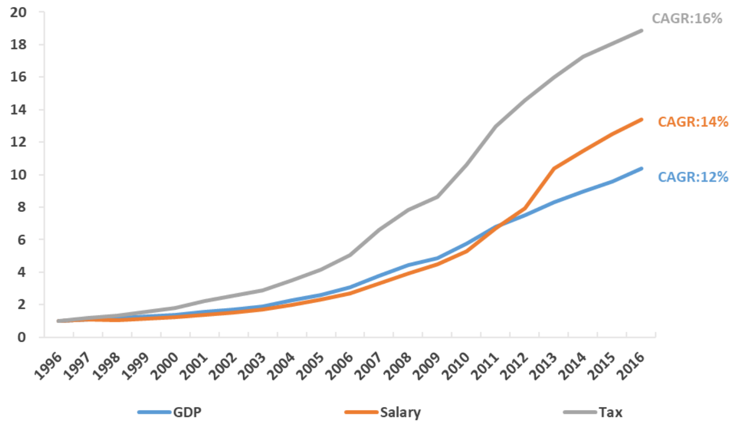
The potential cost savings lie in three areas. Firstly, cost of tax, social security and government fee grew even faster than labor costs in the past 20 years in China. Compared to a prudent monetary policy, China has plenty of room for an expansive fiscal policy to reduce burden of the enterprises; secondly, within the corporate space, profit contribution from finance industry has been lowered, which is a good sign to show that profit distribution has shifted from finance industry to real economy; thirdly, logistic cost that accounts for 15% of GDP has the potential to be lowered after improvement of efficiency and structural changes of economy.

Potential reduction of tax and government fee

Fiscal income of government grew at a CAGR of 16.6% in the past 20 years, and tax which is the biggest contributor of fiscal income soared by 18.9 times since 1996. The growth was much higher than nominal GDP growth and wages growth (Chart1). Central government of China has accumulated plenty of income to maintain a strong balance sheet. What is more, the initiative of Public Private Partnership will help to lower the capital needs of government. While China is

maintaining a tightened monetary policy, fiscal policy will become a good card to play. We believe Chinese government has both willingness and ability to adopt an expansive fiscal policy.

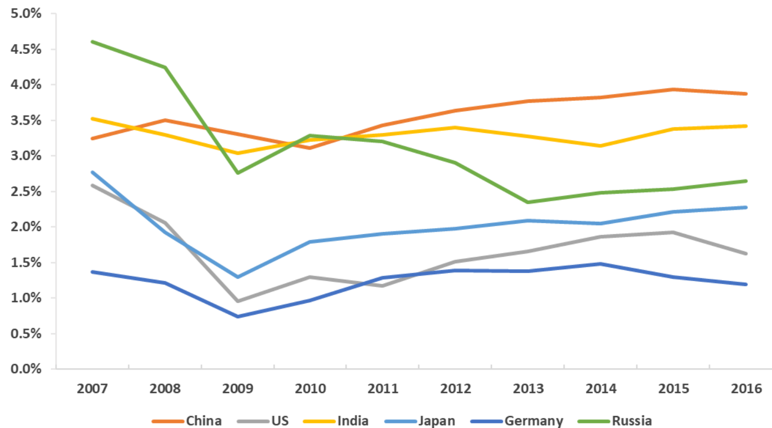
Chart 1: Compound Annual Growth Rate Comparison



Source: Wind, Bin Yuan Capital

Tax burden of Chinese enterprises is high compared to global universe. If we compare the ratio of taxes amount/GDP as shown in Chart 2, the ratio of China is much higher than those of developed countries like US, which implies a much bigger room of tax reduction in China than in US.

Chart 2: Taxes amount / GDP



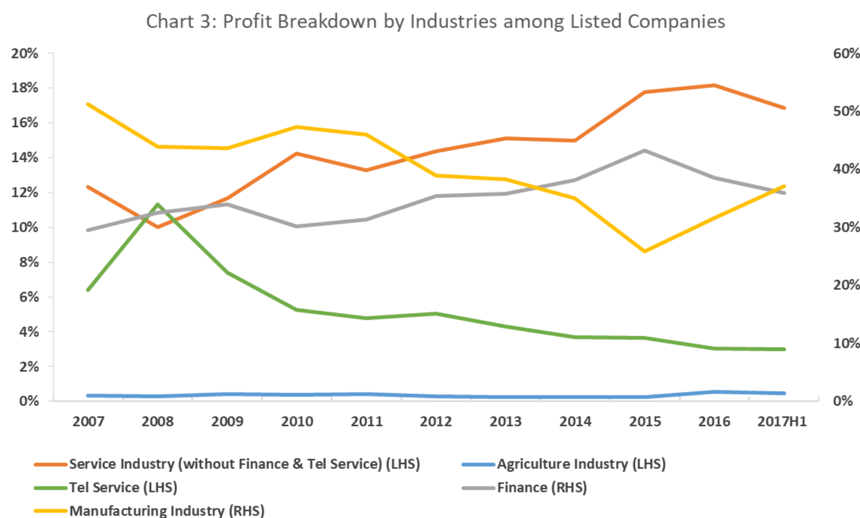
Source: Wind, Bin Yuan Capital

Chinese government has already made an effort to lower the tax burden. For example, the initiative of changing business tax to value added tax (VAT) launched five years ago has accumulatively saved RMB1.7 trillion for corporates. We expect to see more initiatives to come out and the income will be rebalanced from central government towards enterprises.

Profit shift from finance industry to real economy

While capital was circulated within finance system, more profit was generated within the loop. With the capital being shifted to real economy, the result of profit distribution has been reversed since 2016 interestingly. Non-financial sectors earning higher profit incrementally is a good sign for the economy structure (Chart 3).

The consolidation of industries actually helps to de-leverage. Funding cost of large players are lower and overall financing needs can be reduced as large players normally have healthier balance sheet and cash flow and they will no long invest irrationally. The bond yield of China might be on downtrend in the long term, and the open of the bond market to international investors will also help to facilitate the process. As a result, the finance cost of enterprises as a whole will be mitigated.



Source: Wind, Listed companies reporting, Bin Yuan Capital

Logistics cost will be lowered driven by both structural and operational improvements

Logistics cost in China is surprisingly high and it accounts for 15% of GDP, far above US (Chart 4). There are several reasons behind, both structurally and operationally. Structurally, manufacturing sectors, which incur higher logistics cost, account for a large portion of GDP. We believe with increasing shares of service and rising percentage of high value-added manufacturing goods, the logistics cost as a percentage of GDP will continue to get lower in future. Operationally, fragmentation and low information ratio result in low efficiency of logistics industry in China. Multiple layers of distribution lengthen the cycle of logistics and different standards of fragmented players add the difficulty of integration.

Efficiency of logistics need to be largely improved. We have witnessed many companies to make progress in this area. Cainiao (under Alibaba group) is building a platform to enhance the information ratio of the sector and integrate capacities by connecting spare capacity to demand. SF and JD are also building warehouses and other logistics facilities to provide high quality service. Specialized third party logistics players who can provide one stop solution are expected to take market share and automation equipment/system will benefit from the trend definitely. Also, railway transportation with lower cost will take market share from expressway, which is still the dominant transportation way of goods in China.

Source: Wind, Bin Yuan Capital

Conclusion

Tax burden, finance cost and logistics expense are three main cost categories that are likely to be on the down trend to drive China's economic growth in future. The impact of those savings is comprehensive across all industries. In addition, some of spaces will become direct beneficiary specifically. The well managed companies who pursue and drive the improvement of efficiency will be our investment focus.

On the other side, raw material cost may face upside pressure due to stricter environmental requirement and capacity cut, and the gross profit of midstream/downstream manufacturing may suffer from upstream cost hike. We will stick to companies with strong bargaining power to pass through or scalable business model with operation leverage to digest the cost pressure.

Sincerely,

Bin Yuan Capital

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