Bin Yuan Capital All China Strategy – February 2018

Market Update

Chinese stocks retreated in February after January's surge. Shanghai Composite Index was down 6.36% and Hang Seng China Enterprise Index dropped 8.70% in February, both of which were the biggest losses in two years.

The large blue-chip Chinese stocks recorded a strong rally in 2017 and the momentum accelerated into January 2018. The market corrected in February caused by profit taking and the US equity market weakness might be a trigger for the correction. We believe the economy is still solid and a healthy short-term adjustment is needed after the capital gain accumulated for the past 18 months. Based on our analysis, we found that after the large-cap blue-chip stocks outperformed significantly in 2017, some of the mid-cap growth-driven stocks we focus on are getting attractive in terms of valuation to growth and we believe their performance will catch up in the future.

China's economy was generally in line with the expectation in February. The producer price index (PPI) rose 3.7% year on year (YoY) in February 2018, down from 4.3% in January 2018. The consumer price index (CPI) moved in the opposite direction by rising 1.4 percentage points to 2.9% YoY. The official manufacturing Purchasing Managers' Index (PMI) dropped to 50.3 in February 2018 from 51.3 in January 2018 and the official non-manufacturing PMI in February was down to 54.4 from 55.3 in January primarily due to the accelerated growth of the service sector. Both manufacturing and non-manufacturing PMI was well above the expansion/contraction threshold of 50. Rail cargo volume increased by 9.4% YoY in January to reach about 340 million tons.

Tax reduction in the form of Value Added Tax (VAT) reform achieved good results in 2017. According to the State Administration of Taxation, VAT reform saved relevant companies RMB918.6 billion in total in 2017, representing a 60% increase compared to RMB574 billion in 2016. VAT reform expanded nationwide in May 2016 and the tax reduction will further benefit service-oriented sectors by easing tax burdens in the following years.

Mobile payments in China reached RMB81 trillion as of October 2017, making China the largest mobile payment market in terms of payment volume. The volume was significantly higher than RMB58.8 trillion in 2016. China skipped the credit card usage as cashless transactions are more and more popular across the country. According to a research conducted by China Internet Network Information Center, 35% of mobile users prefer to make mobile payments while only 31.8% still prefer using credit cards or cash. It showed that China started to lead in some technology applications through its continuous innovations.

Performance Attribution

At the stock level, a handset camera module supplier outperformed in February primarily because that the company announced a positive profit alert, which said that the profit attributable to owners of the company in 2017 increased by over 120%. We have seen optics upgrade on different terminals: 1) the upgrade of handset camera module (HCM) on smartphone from single-cam module to dual-cam module, which brought a higher margin and shipment volume; 2) trend of autonomous driving required more high-end vehicle cameras, which gave a rise to shipment volume of vehicle lens set (VLS). In 2018, the company will focus on the improvement of product mix and increase the proportion of high-end HCM and VLS.

A leading commercial bank underperformed in February. Although stricter and unified regulations of the financial sector issued recently put some pressure on the stock price, we believed they would benefit the banking sector as a whole in the long run. The commercial bank has higher exposure to the retail banking compared to its competitors. On the one hand, it has advantages in getting cheap deposits to support its loan growth. On the other hand, we still prefer retail banking to corporate banking because the retail channel will create substantial value in wealth management business as Chinese people are getting richer.

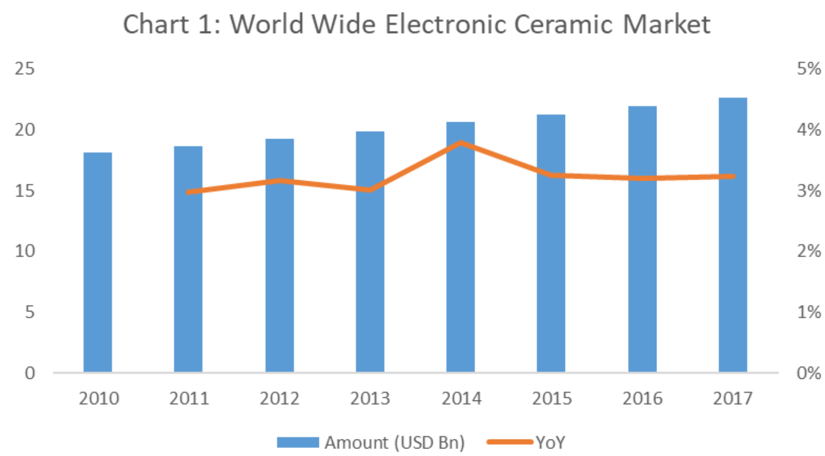
Local Insights and Portfolio Positioning

The upgrade of people’s demand towards smarter and better-connected way has been driving tons of new opportunities of traditional products and materials. Ceramic is one of them with wider emerging advanced applications. With the booming innovation and development in personal electronics, communication and industrial applications, electronic ceramic industry is quickly evolving these years. Compared with other basic materials, electronic ceramic has such competitive advantages as good heating diffusion, anti-radiation ability, high hardness and superior endurance. Existing key players with high technology advantages, dominant market share and cost-efficient products are expected to benefit more and grow quicker in the next few years.

Electronic Ceramic Industry

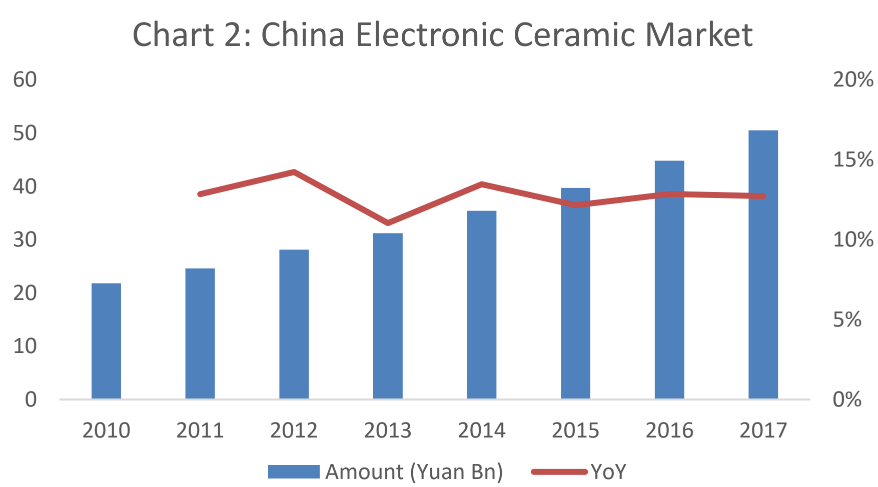
Electronic ceramic, a branch of advanced ceramic, refers to the ceramic material used in electronic components. It is made of artificial refined inorganic powder with precise chemical composition to achieve certain performance. Ceramic powders are the most important raw materials for making ceramic components. High purity, ultra-fine, high performance ceramic powder manufacturing technology, advanced and experienced manufacturing process are the key bottlenecks of electronic ceramic industry.

With the rapid development of communication, computer, cellphone and other downstream applications, the electronic ceramic industry has maintained a steady growth in the past 7 years. The total market size of electronic ceramic in 2017 reached USD22.6 Billion (Chart 1) and thanks to the emergence of new demand like Internet of Things and 5G, it is expected to keep a stable compound annual growth rate (CAGR) of around 3% globally in the next few years.



Source: 2018-2024 Chinese Electronic Ceramic Industry Depth Assessment and Investment Strategy Forecast Report, Bin Yuan Capital.

The Chinese market, which has one of the largest world's demand for electronic ceramic components, will grow much faster. The demand for electronic ceramics in China increased from RMB21.8 billion in 2010 to RMB50.5 billion in 2017, with a CAGR of about 12.8%. (Chart 2)



Source: 2018-2024 Chinese Electronic Ceramic Industry Depth Assessment and Investment Strategy Forecast Report, Bin Yuan Capital.

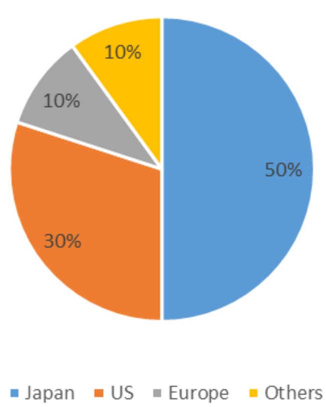
New demands

Because of high hardness, superior endurance and skin-friendly properties, electronic ceramic started to be applied in wearable products, such as Apple Watch which used electronic ceramic as its back cover. Cellphone back covers are usually made of metal, glass and plastics, but electronic ceramic is penetrating into this market now. Also, since new technology like wireless charging and 5G emerges, metal case is not suitable for cellphones but ceramic can be a good alternative with anti-radiation ability. Currently, electronic ceramic has been used in several cellphone models, e.g. Xiaomi Mix2, Xiaomi Mi6, Huawei P7, Essential Phone. But the penetration rate of ceramic case is still low, less than 1%.

Opportunities for Chinese Players

Due to high technology barriers, the electronic ceramic industry has long been monopolized by leading Japanese and American companies. The market share of Japanese players accounts for 50% of the global electronic ceramics market. The American companies take up 30% of the total market share. (Chart 3) Major players in this market include Kyocera, Murata, Tokuyama, Sumitomo Chemical, TDK, Coorstek, Rogers and others. Kyocera is the leading ceramic company. It started the electronic ceramics business 60 years ago and it provides ceramic substrates, Surface Mounted Devices (SMD) package, Ferrule, capacitor and etc.

Chart 3: Electronic Ceramic Market Share



Source: 2018-2024 Chinese Electronic Ceramic Industry Depth Assessment and Investment Strategy Forecast Report, Bin Yuan Capital.

The '13th Five-Year Development Plan for New Material Industry' listed electronic ceramic as one of the key strategic materials and proposed to speed up the industrialization of electronic ceramic. Chinese players, especially the leading ceramic companies, who have combined the accumulated technology know-how and highly cost-efficient manufacturing process will benefit from the big market size of import substitution. The leader might even surpass Japanese players in certain technology fields and continually takes market share from them.

Stock Implications

CCTC (300408.SZ) was founded in 1970s and has been focusing on electronic ceramic for over 40 years. It has a strong technical barrier and is highly vertically integrated. CCTC had the highest net profit margin (over 30%) among peers in the previous years because of the technology barrier and its integrated manufacturing including self-made powder and self-designed equipment.

- CCTC is the leader of the hi-tech ceramic business in China and is the No.1 player in ceramic ferrules segment with around 70% to 80% market share worldwide. It will benefit most from the development of 5G and data center.
- Apart from leading the ceramic ferrules business, CCTC is the only capable Chinese company in ceramic package and its market share is around 6% only. The market kept consolidating and CCTC, as the market leader in this business, kept taking up market share.
- CCTC is the only player with whole process capability of ceramic case for cellphones and has succeeded to supply its products to Xiaomi. The cost of CCTC's unique powder for cellphone cover is almost half of its of competitors' while the product qualities are similar.

In conclusion, we believe leading companies like CCTC are expected to grow quickly in the next few years in China and we will continue to pay attention to relevant new technology, application progress and government policies to monitor the companies' development.

Sincerely,

Bin Yuan Capital

Specialized China Manager	• Shanghai/Hong Kong-based, value focused China manager • Long only absolute return mindset • $600M+ AUM invested in All China and China A share strategies
Experienced Team	• Founders with 35+ years combined investment experience • Core team formerly with GE Asset Management ("GEAM") managing $5B across 3 funds; EM, Greater China & China A Shares
Fund Fee Structure	• Class A – Management Fee 1.5% • Class B – Management Fee 1%, Performance Fee 10% • Class C – Management Fee 2%, Performance Fee 20%