Bin Yuan Capital All China Strategy – First Quarter 2018

Market Update

Shanghai Composite Index was down 4.18% while Hang Seng China Enterprise Index increased 2.47% in the first quarter of 2018. The large blue-chip Chinese stocks recorded a strong rally in 2017 and the momentum accelerated into January 2018. The market corrected in the rest of Q1 caused by profit taking and the US equity market weakness might be a trigger for the correction. What is more, on 22 March 2018, US President Donald Trump signed a memorandum that could impose tariffs of as much as USD60 billion on Chinese goods. In response to that, China also unveiled plans to impose tariffs on products from the US. We will discuss the potential trade war's impact later in Local Insights Section.

The first quarter witnessed evidences of the economic stabilization of China. In the first two months of 2018, China's power use rose 13.3% YoY and industrial output increased 7.2%, 1 percentage point higher than December 2017. The National Bureau of Statistics (NBS) surveyed 41 industries and 29 showed positive YoY profit growth in the first two months of 2018. Industrial companies of over 20 million annual revenue reported a net profit growth of 16.1% YoY. The official manufacturing Purchasing Managers' Index (PMI) rebounded to 51.5 in March from 50.3 in February and the official non-manufacturing PMI in March was also up to 54.6 from 54.4 in February. Both manufacturing and non-manufacturing PMI was above the expansion/contraction threshold of 50. Rail cargo volume increased by 8.2% YoY in February to reach about 304 million tons. In addition, Chinese government's deleveraging effort also showed positive impacts. Leverage ratio dropped 0.8 percentage points. These data showed a good start for the economy in 2018.

MSCI announced to launch 12 new China-related indexes on March 14th. These indexes cover small and medium-sized companies and provide more references for global investors. According to China Daily News, the global investors only allocated 10% of their funds to emerging markets and even less to China market currently. However, with A-shares' inclusion into MSCI's indexes, more and more global investors will increase their weight in China and this trend will bring more liquidity into China's stock market.

China plans to introduce two new policies to attract more quality companies to get listed on the domestic bourses. Firstly, a system of Chinese Depository Receipts is planned to get overseas listed companies back to the domestic A-share markets. Secondly, IPO application approval will be fastened for valuable companies in biotechnology, cloud computing, artificial intelligence and advanced manufacturing industry. These new policies are very important for both enterprises and investors. For enterprises, it will be easier for them to raise money on the domestic bourses where investors usually understand them better and willing to pay higher valuations. For investors, they will be provided with more choices in investing in good companies.

Starting from May 1, China will cut value-added tax (VAT) rates by 1 percentage point. As part of the tax cut package, eligible companies will receive tax rebate for investments in machines, plants and related facilities. According to the market's estimation, this tax rate cut will amount to around RMB400 billion and might increase the net profit of the listed companies by around 3% to 7%.

Performance Attribution

At the stock level, a medical instrument company outperformed in Q1 2018 primarily because its 2017 earnings growth forecast of about 20% was slightly beyond market's expectation. The company brings professional health management concept and advanced product solution into daily life, makes an ecosystem consisting of homecare medical, clinic medical and internet medical, as well as builds up a professional and comprehensive medical service platform. We believe that with its well-known brand, strong M&A capabilities and its strong channel of distribution, the company will continue to gain market share and expand into other categories.

A recliner manufacturer underperformed in Q1 2018 primarily due to the market's concern on the potential trade war between China and the US that might hurt the company's export business. However, with the fast development of its domestic business, the company's domestic business has now become a major contributor of the net profit growth and we expect the trend will continue. In addition, we also think that the current valuation has also factored in all the downside risks. Due to the company's well-known brand in China and its highly vertically integrated supply chain, we believe it can still maintain its cost leadership position in the recliner industry worldwide and will continue to expand its business in other categories such as mattress.

Local Insights: The Impact of The Recent Trade War to China, If There Is One

President Trump decided to increase tariffs on certain products imported from China to reduce trade imbalance between the US and China on March 21st, 2018. China has responded with the announcement of increasing tariffs on US imported products. The potential trade war has raised concerns among investors and the financial markets reacted negatively.

Chinese high-end manufacturing and technology industries that export to US are in the spot light of the trade war from US. This seems to be a strategic decision made by Trump's administration. On the US side, the frustration of current large trade deficit and future trend is not groundless. China benefited greatly from globalization and manufacture outsourcing led by US corporates. Not only has the competitive labor force helped China become a manufacturing powerhouse, but also the offering of domestic market to exchange for technology transfer has aided China to move up quickly on the production value chain. Some US manufacturing firms has felt increased pressure in recent years. They are frustrated to keep up because they struggle to tap in and do business in China while protecting their technology IP. The combination of President Trump's ambition to make US great again and his key staff's hostile attitude toward China has made this US administration politically ready to attack China economically.

No benefit to both sides

The trade imbalance is caused by economic structure needs that the US outsources its less competitive sectors to other countries including China, which is benefiting both the US and the Chinese economy. The US and the global economy is in solid recovery, which also indicates that the global economy is balanced. Reverse current balance will be disruptive. The potential trade war might, in short term, bring down the trade imbalance between the US and China. Since the US is still a major export market for China, China would be in a weaker position if there is a trade war. China does not have a strong enough economic method to retaliate against the US tariff increase, but on the other hand, the trade war will have impact to the US consumers and they will suffer from higher inflation. It would also be negative to consumers if the FED were to increase the interest rate. The expected higher inflation would cause the US dollar to be weaker and make RMB stronger. That would also make Chinese goods more expensive to purchase. The trade war will negatively impact the US corporate as China today has a huge consumer market and they may lose competition to other major global competitors if China make them difficult to do business here.

Too late to stop China to gain competitiveness

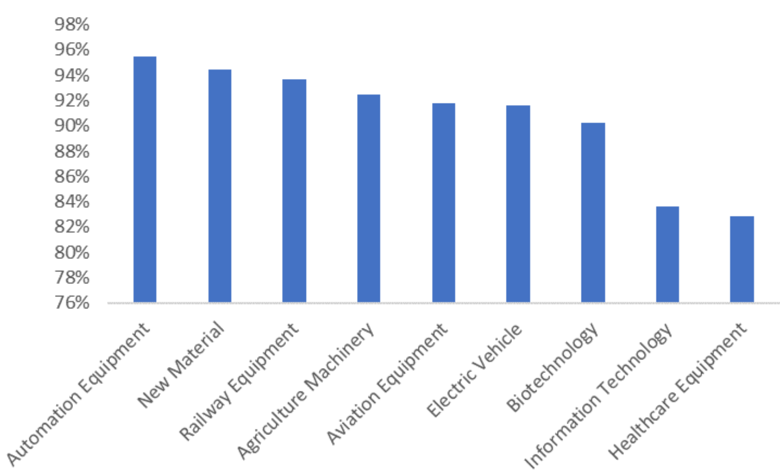
Although trade war will not be good for China in the near term, the negative impact to Chinese economic growth will not be dramatic. China's economy is strong enough to defend the trade war.

The economic structure is better balanced today. Net export influences China GDP less now. According to National Bureau of Statistics, almost 60% of GDP is driven by consumption, 32% by investment and 9% by net export. In the past forty years, China completed the first stages of building infrastructure by construction of extensive logistics network and increasing urbanization from 10% to 58%. These structural changes have made the domestic economy healthier. As a result, China has lifted more than 1 billion people out of poverty by our estimates and created the largest middle class in the world which helped the consumption of domestic produced goods and services.

The competitiveness of Chinese high-end manufacturing space, especially in electromechanical goods and equipment have improved dramatically in the past decade and Chinese players continued to take global market share. The purpose of the investigation on IP and restriction of Chinese companies' technology M&A in the US is trying to slow down this process. However, it might be too late. The Chinese workforce has migrated from cheap labor to skilled workers. China has already grasped know-how in many areas, built well-developed infrastructure and supply chain, accumulated adequate capital on R&D and fostered huge domestic market to support.

The competitiveness of Chinese high-end manufacturing and technology space will continue to be strengthened, even with the attack from US. Technology wise, China will focus on R&D in house and continue to improve IP protection framework. The recent fast approval of A-share IPO in advanced technology space shows the strong determination of Chinese government to allocate abundant resources to high-tech enterprises; Cost wise, as we mentioned in the newsletter of the third quarter of 2017, Chinese government has both willingness and ability to reduce tax burdens of enterprises, especially for those high-tech companies. Also, the trend of industry shift from coastal expensive cities to inland cheaper low tier cities is very positive. It not only helps to reduce the cost of enterprise, but also created more jobs in those areas to improve purchasing power; Market wise, China is extremely good at application innovation and the fostered domestic market is huge to support the development of advanced goods and services. According to our calculation (Chart 1), domestic market accounts for a majority of demands of Chinese high-tech sectors and it helps to defend themselves amid the potential trade war from US.

Chart 1: Domestic Sales % as of Total Sales in 2016 (All A Share Listed Companies of Sectors)



Source: Wind, Company Disclosure, Bin Yuan Capital

<u>External force to accelerate reform progress in China</u>

We believe that in the long run, China will benefit from the US imposing trade penalty on China. Those sectors, such as steel, that the US focusing on are in oversupply situation and the tariff increase will be an external force to help the sector to consolidate. The trade negotiation will become an external force to help China speed up to open up some sectors to reform, like finance and auto. It will help to push those domestic less efficient players to be more competitive. China has made major progresses in IP protection and the country needs to do more in this area. This can help China to lift its global image as well.

The uncertainty of the trade war brings volatilities to the Chinese equity market. However, the trend of economy restructuring changes towards upgraded domestic consumption/services and high-end manufacturing goods/services in China is still intact, even moving at faster pace stimulated by external challenges. In our portfolio, we will continue to stick to high quality companies with strong competitiveness and huge domestic market demand.

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%

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