

Bin Yuan Capital All China Strategy – May 2018

Market Update

Chinese stocks performed variably in May. Shanghai Composite Index was up 0.43% in May while Hang Seng China Enterprise Index was down 2.86%.

China's economy performed a little bit better in May. The Producer Price Index (PPI) rose 4.1% year on year (YoY) in May 2018, up from 3.4% in April 2018. The Consumer Price Index (CPI) maintained flat at 1.8% YoY in the same period. The official manufacturing Purchasing Managers' Index (PMI) rose from 51.4 in April to 51.9 in May, and the official Non-Manufacturing PMI also rose from 54.8 in April to 54.9 in May. Both manufacturing and non-manufacturing PMI was still above the expansion/contraction threshold of 50. Rail cargo volume increased by 1.4% YoY in April to reach about 305 million tons.

Starting from May 1, China quadrupled the daily quotas for Mainland-Hong Kong stock connect preparing for the possible capital inflow after the official inclusion of China A-shares into the widely tracked MSCI indexes in June. Per Wind and MSCI's data, China shares' weight in MSCI ACWI is 4.1%, which is too low to match China's 14.8% share of the world gross domestic product and the USD17 trillion valuation of China's equity and bond markets. The opening up of the Chinese capital markets will attract investors around the world to share growth in the Chinese market as well as foster a mature and rational investment style.

A total of 3,521 companies listed on the Shanghai and Shenzhen stock exchanges completed releasing their first-quarter results of 2018 by the end of April. The YoY revenue growth of A-share listed companies slowed down from 12.6% in 2017 to 11.9% in Q1 2018, while the YoY net profit growth also slowed down from 16.6% in 2017 to 15.6% in Q1 2018. Approximately 580 companies saw their profits doubled, while 336 companies saw their profits up 50% to 100%. This good result was primarily attributable to China's supply-side structural reform and improvements in the economy. The A share holdings in our portfolio recorded the average earnings growth of 23% in the first quarter, much higher rate than the overall market.

Performance Attribution

An online Animation, Comic and Game ("ACG") community outperformed in May mainly due to its strong first quarter financial result. The revenue reached RMB868 million with 105% YoY growth. This strong quarter demonstrated that the monetization of the company was going well. We believe this company has the dominant position in ACG industry and will continue to benefit from the rapid growth of Animation, Comic and Game culture.

A retail commercial bank underperformed in May. We believe stricter and unified regulations of the financial sector will bring benefits to the banking sector. Banks that have advantages in getting cheap deposits will stand out. This retail commercial bank has higher exposure to retail banking compared to its competitors, which ensures that it can get more cheap deposits. We prefer retail banking to corporate banking because the retail channel will create substantial value in wealth management business since Chinese people are getting richer.

Local Observation and Portfolio Positioning

The generation born between 1990-2009 is called Generation Z in China, with a total population of around 328 million. As Generation Z generally grows up in a more prosperous living environment and with more personality than previous generations, their demands for entertainment are higher and make sub-cultures become increasingly prevalent.

Animation, Comic and Game (ACG) are the most popular entertainment contents of Generation Z in China. The market size of ACG reached RMB300 billion in 2017, and is expected to grow at a double-digit growth rate in the following 5 years. A high-quality company in this huge and fast-growing industry cannot be missed by investors like us.

Bilibili is a top online ACG video community widely cherished by Generation Z. In Q1 2018, Bilibili had a total of 77.5 million Monthly Active Users (MAUs), among which 82% are Generation Z, and each active user spent 76 minutes per day on it. In the past 2 years, Bilibili's MAU tripled benefiting from the growing penetration of ACG culture in China.

We expect that Bilibili will continue to be dominant in the ACG video community and grow quickly primarily due to the following reasons:

1. **High user stickiness.** Bilibili is not only an online video platform like iQiyi and Youku, but also an online community of ACG culture. The fans of ACG culture get together and share their views with others who have similar interests on Bilibili. In Q1 2018, 221 million interactions took place on Bilibili, which meant that averagely each registered user had 8 interactions during the quarter. In an online community, users are more likely to develop friendships and have sense of identity with others, which enhances the stickiness of the platform. This can also be proved by Bilibili's first-year user retention rate of 70%.

Picture 1: Users enjoy posting opinions and interacting with each other.



- Strong Content Barrier.** Instead of buying content or making content, Bilibili went a different way in generating content. 89% of its content is user generated content (UGC), as a result of which, Bilibili's content cost is less than 10% of its revenue. Content creators are encouraged to produce high quality videos in this community, as the high-quality contents can obtain fans' recognition and even financial returns. In Q1 2018, the number of active content creators reached 0.88 million and the number of video created increased 154% to 2.74 million. As the most creative ACG video community, Bilibili has a strong content barrier.

Picture 2: UGC content is the most popular type of content on Bilibili. (Times played for the first video: 1.61 million)



3. **Culture maker and strong brand.** Due to good management and solid strategy, Bilibili gradually becomes the dominator of Chinese ACG culture. In the view of Chinese young generation, Bilibili is the representative of ACG culture, which allows Bilibili to lead the culture and build a brand. The strong brand of Bilibili makes it possible to expand its business offline. In 2018, Bilibili Macro Link and Bilibili World attracted over 1 million audiences offline, which demonstrated its significant brand influence.
4. **Expanding coverage of themes.** Bilibili is starting to expand its content coverage from ACG to other popular themes that Generation Z is interested in. In Q1 2018, the videos of lifestyle and entertainment contributed over 30% of total clicks. Bilibili are transferring from an ACG video community to a community of young generation interests.

Currently, the monetization methods of Bilibili on its traffic are game distribution, value added services and advertising. In Q1 2018, although over 80% revenue of Bilibili came from the game segment, revenue from value-added services and advertising grew faster than the game segment. The management hoped to lower revenue from the game segment to around 50% of the total revenue in the future. In Q1 2018, the Average Revenue per Monthly Active User (ARPU) was USD11.1, which was still much lower than MOMO, Tencent and iQiyi's. The ARPU is relatively lower primarily because Bilibili's monetization is still in its early stage and the consuming ability of young generation is still at a relatively low level for the time being, which also means Bilibili's ARPU still has much potential to increase.

We believe that Bilibili can continue to increase its penetration rate in China's young generation with its wider coverage of content themes and will play a more and more important role in China online entertainment industry.

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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