
Bin Yuan Capital All China Strategy – December 2019

Local Observation and Portfolio Positioning

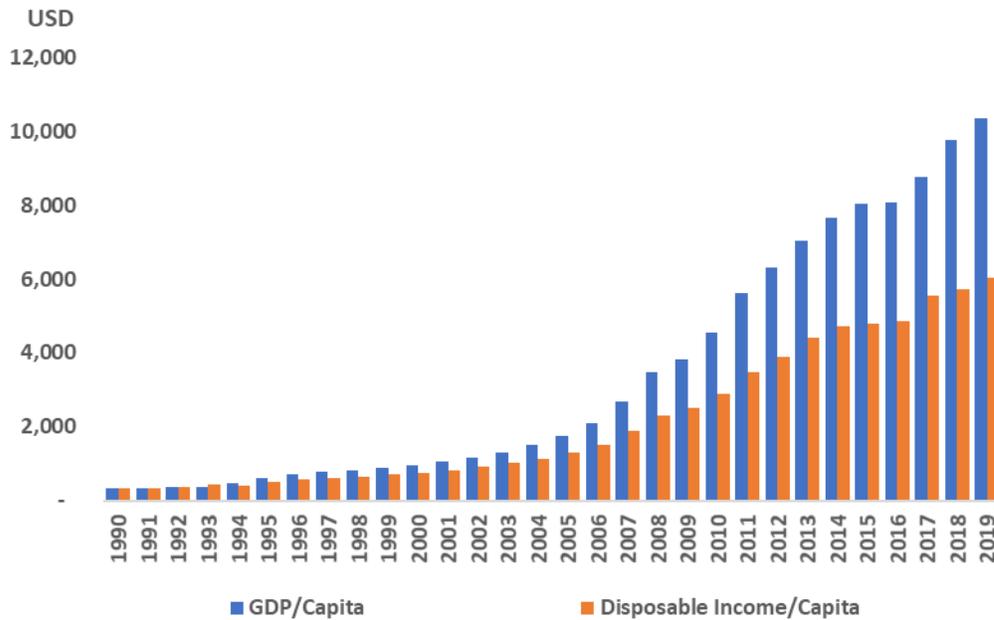
The China equity market has registered a positive return of 29.7% in the year of 2019. Despite the trade war between US and China that caused concern on already slowing Chinese economy and the level of debt, the economy structural transformation from investment led growth to consumption and service, from lower end to high end manufacturing has continued on track that boosted the confidence of investors.

2020 should be a year with steady value appreciation and lower volatilities for China equity market. After past few years supply side reform, money supply reduction and deleveraging, the balance sheets at both corporate and government level are much healthier. The market will be immune to the trade talks. Consumer spending shall continue in 2020 with modified inflation, government will gradually provide liquidity to the economy to make sure the growth to stay at close to 6% level. We expect corporate earnings to improve for the year. The improved investors' confidence should support a healthy equity market.

Next Decade Economy Outlook

China has gained significant social and economic benefits from the domestic reform and the wave of globalization. In the past 30 years, China has established a world-class manufacturing supply chain, has built a second to none transportation infrastructure, has trained sufficient educated and skilled labor force, has accumulated abundant capital and household savings. The miracle is accomplished in such a short time period and China's GDP per capita increased from USD318 in 1990 to USD10 thousand in 2019 and has lifted 650 million people out of poverty. China today has the largest middle-class population with around 139 million people enjoys USD10 thousand annual disposable income per capita. As a result, China has fostered a huge domestic market.

Chart1: China's GDP per Capita and Disposable Income per Capita.



Source: Wind, Bin Yuan Capital

Thirty years ago, China was classified as a poor country with no influence to the global economy. Today she stands at the second in total GDP and is expected to surpass the US before 2040 (We estimated the compound annual GDP growth rate is 2% in US and 5% in China). In the meantime, China's relationship with global powers have changed, particularly with the super-power – the United States. The US has changed its views on China as a competitor instead of a partner. The trade war, or call it trade relation rebalance, will be inevitable in the future. So what is going to happen in China in the next 10 years and where shall we, as an investor in China, to invest our capital? We believe continuous household living standard upgrade and labor productivity improvement through innovative technology application will be the two major areas of focus.

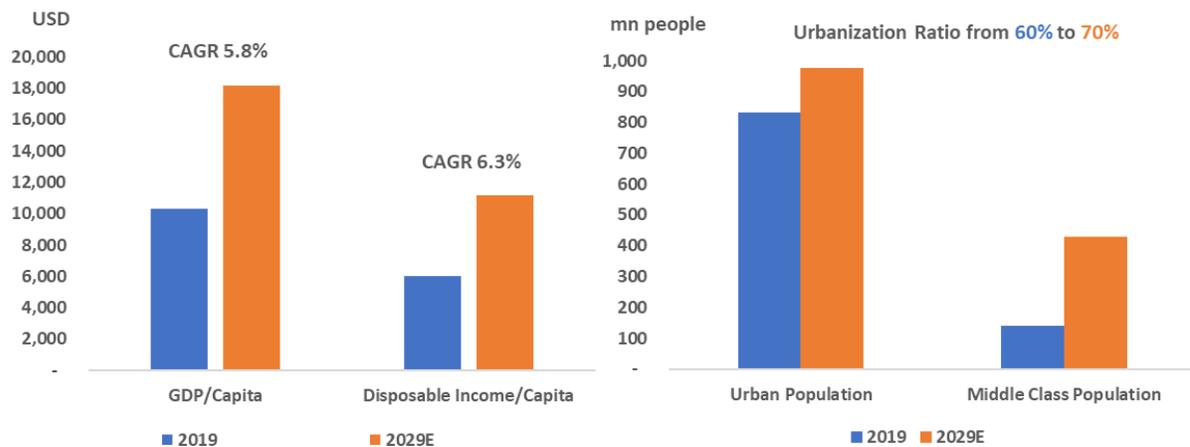
Domestic Economy

China has transformed from an export-oriented economy to a more domestic consumer living standard improvement economy. 10 years ago, the net export contributed 9% of the GDP and today it is merely 1%. External factors have much less impact to the economy with domestic consumer spending contributing to 76% of the GDP growth compared to 44% a decade ago. In the past thirty years, 545 million people moved to live in urban and this progress aided GDP growth and expanded the consumer market from RMB 0.8 trillion to RMB 40 trillion.

This urbanization has not completed, and continued urbanization will be enough for China to maintain at a reasonable economic growth rate. The well-built infrastructure will help to make the successful migration possible. China still has 1 billion people who reside in low tier cities and rural area, 3 times of the whole population of US. In the next decade, the urbanization level is

expected to rise from 60% to 70%, resulting that 1 billion people will have the purchasing power more than the current urban level, an annual disposable income of USD 6,056 per capita. Middle-class of China will soar from 139 million to 428 million, according to National Bureau of Statistics and Bin Yuan estimate. By the end of the next decade, Generation Z (Birth between 1990-2010 with 330 million people) will grow to mainstream consumption group with much higher capability and willingness to spend money. We estimated the total consumption market will reach RMB72 trillion at a compound annual growth rate of 6%.

Chart2: Urbanization Continues to Drive Economic Development.



Source: Wind, Bin Yuan Capital

Value Creation from Innovation

Thanks to the globalization, China has possessed a well-trained labor force. In addition to large number of civil engineers who can build mega bridges and high-speed train in a most efficient way and scientists in the area of various of industries, it has a global competitive team of experts and software engineers in information technology. China software engineers are globally competitive in developing internet-based application platform that link business to business, business to consumers and consumers to consumers. The huge domestic market also serves as a scalable demand to monetize and reinforce innovation. China today has the most advanced online-based economy. This trend shall continue which, with the implementation of 5G technology, will offer vast investment opportunities in the next decade.

Investment Opportunities

The visible benefits that information technology improvement has contributed to the global economy is the massive improvement of social and business efficiency. The improved efficiency has lifted labor productivity and smoothed out most of the cyclical factors that experienced in the

industrial dominated economy. The labor productivity and social efficiency advancement have brought in extended period of higher income growth associated with lower consumer headline inflation, which shall lead to wealth creation and stimulate consumption.

In the information space, we are in favor of those that are innovative in building online profitable business platform – both able to save and consume users time, those that supply hardware and software to the online service businesses; In the consumer space, Bin Yuan focus on those who are building a long term business that provide high quality consumer products and services, are able to maintain pricing power and able to become sector leaders.

The companies that are customer focused and value creation through innovation will be Bin Yuan’s investment focus and be illustrated below:

1. Providing customized service with strong pricing power

With the improvement of living standards, non-standardized service demand has begun to emerge. People are willing to pay more for those high-quality services and the companies within the industries have bargaining power to raise prices.

- **Pay for happiness:** Young people have very diversified interests for digital contents and cultural and entertainment products, for which they are willing to exchange their time for fun with money. Pan-entertainment communities, such as Bilibili (BILI.O) and Kuaishou (Planned IPO in 2020), provide a platform for young people to explore their interests and create online content to share with others.
- **Pay for convenience:** With the increased awareness of value of time, convenience is something people are willing to pay. For instance, people are willing to pay a premium for faster and safe logistics delivery, S.F. Holding’s (002352.SZ) is the leading provider. Take-out food delivery service is now a necessity for lots of people. Once people are used to the convenience, they cannot get rid of it. That is why Meituan Dianping (3690.HK) can firmly bind users. In the home furnishing business, consumers are inclined to engage a total solution provider for saving time. Oppein’s (603833.SH) integrated services of furniture have been well received.
- **Pay for alleviation of anxiety:** The education of children and medical service are long term themes in China with cost hiking much faster than inflation. Buying “protection” including insurance, medical services and giving children a better education can alleviate people’s anxiety. Top healthcare service and education resources are always scarce, which enjoy a strong pricing power. Therefore, education companies such as TAL (TAL.N), Koolearn (1797.HK), and medical companies such as Aier Eye Hospital (300015.SZ) are beneficiaries. People getting wealthy also care more about their appearances and are eager to take cosmetic surgeries to get a better and younger look. Companies that

manufacture raw materials hyaluronic acid, such as Bloomage Biotechnology (688363.SH), will benefit from this fast-growing beauty market.

Scalability for non-standardized demands is very important in assessing business sustainability. Brands with network effect, expandable platform and the chain value are the key factors. S.F. Holding (002352.SZ) in logistics industry and Meituan (3690.HK) in online service industry have advantages of network effect and they grow with economies of scales so that second players are difficult to compete. BILIBILI (BILI.O) and Kuaishou (Planned IPO in 2020) in short video industries are scalable platform pooling diversified interests and user generated contents to attract and retain customers. HUAZHU (HTHT.O) in hotel operation industry, Aier Hospital (300015.SZ) in healthcare service industry and Oppein (603833.SH) in customized furniture industry have developed chains of sites with branding barriers which allow them to consolidate the market.

2. Benefiting from consumption growth in low tier cities

With 1.4 billion people scattering over more than 3,000 tier 1 to tier 6 cities and rural areas, the level of consumption is quite segmented. Consumer products and services penetrating to lower tier cities will provide great growth potential in the next decade.

- **Increase penetration rate in lower tier cities:** Low tier cities consumption for better life is just a beginning: Tissue consumption per capita in China is expected to grow from 6.5 kg/year to 11 kg/year in the next decade, compared to 25kg/year in Japan. Quality tissue consumption per capita in low tier cities is much lower than the national average which shall have strong growth in demand. The number of air conditioners per family will grow from 1.0 to 1.8 units in the next 10 years, vs 2.8 for Japan now. The consumption of liquid milk has a lot of potential. Yili (600887.SH), as the leading dairy enterprise in China, has 1.7 million sales outlets and is the biggest distribution network in the industry. It will continue to expand to more than 3 million sales outlets nationwide. The per capita consumption of liquid milk is going to grow from 20 kg/year to 30 kg/year in the next 10 years.
- **Consolidation:** People in lower tier cities have a strong tendency to buy products and services with good brands and quality. In the customized furniture industry, national brands such as Oppein(603833.SH) are replacing those local brands due to its better quality, brand image and total solution services. Its market share is expected to rise from 8.5% in 2019 to 20% in 2029. In education and training industry, the leading companies that succeeded in first and second tier cities are accelerating the consolidation process in low tier cities. The CR2 of K12 tutoring industry was 5.3% in 2018 and will grow to 20% by 2029. In the hotel industry, national chain hotels are also taking shares from local independent hotels with better brands, services and membership programs. Huazhu

(HTHT.O), the second largest hotel chain in China, will continue to gain room nights market share from 4.5% in 2019 to 9.8% in 2029. With penetration to lower tier cities, C&S Paper (002511.SZ), the 4th largest household tissue manufacturer in China, will also expand its market share to over 10% in the next decade.

Chart3: Industry Consolidation.

Industry	2019 Market Size (billion RMB)	Industry Annual Growth Rate	Dominant Company	Market Share in 2019	Market Share in 2029E
<i>Hotels</i>	500	8-10%	Huazhu	5%	10%
<i>Home Appliances</i>	800	6%	Gree	25%	35%
<i>Household Tissue</i>	100	8-10%	C&S Paper	6%	10%
<i>Customized Furniture</i>	300	10%	Oppein	8%	13%
<i>Liquid Milk</i>	220	8%	Yili	29%	39%
<i>Education</i>	500	10%	TAL	4%	11%

Source: Company Report, Wind, Bin Yuan Capital

3. Improving supply chain efficiency

Information technology has made supply chains much more efficient for products and services to reach customers. Data are much easier to be accumulated during online transaction which can be analyzed for business on the whole value chain. The consumer data feedback to manufactures (C2M), helps the manufacturers to save cost by better budgeting their volume production and inventory. E-commerce platform such as Pinduoduo (PDD.O) and Alibaba (BABA.N) play an important role in C2M, which makes mass customization possible by collecting orders from customers before goods are manufactured. E-commerce platforms reduce production cost and the cost to reach customers. Reduced merchandise prices and more accurate targeting customers stimulated more consumption. The interactive features of online entertainment network such as live broadcasting and short-form videos are also being used by merchants to improve marketing efficiency, and Bilibili (BILI.O) and Kuaishou (Planned IPO in 2020) platform are mostly preferred to attract traffic.

4. Building Information Technology infrastructure to boosts end user demand

China's investment focus is shifting from Steel-based to Information Technology based infrastructure, which is served as foundation for further development of digital economy. The infrastructure of advanced telecom technology and cloud services will highly improve the efficiency of data transmission, storage, communication and usage, which will facilitate the upgrades of terminals such as smartphone, wearables, Internet of Things and automobile.

- **Smartphone:** 5G telecom technology with faster speed stimulates the growth of data and its usage, boosting the massive upgrades of smartphone terminals, such as optical module, antenna, power amplifier and filter, etc. Sunny Optical (2382.HK), a top optical solution supplier in China will benefit from rising demand for sensors on electronic devices, including camera or Time of Flight (ToF) module.
- **Wearables:** Increasing numbers of wearables devices which bring convenience or new functions like Airpods, smartwatch, AR glasses will be launched in the next decade. Wearables break down the functions within a smartphone into smaller different products, which makes the precise manufacturing increasingly important. For example, laser equipment and System in Packaging (SiP) technology are getting popular in electronic manufacturing, helping Luxshare (002475.SZ), the best electronics manufacturing supplier, to continue to gain competitiveness.
- **Internet of Things (IoT):** The integration of Artificial Intelligence (AI) and Internet of Things (IoT) is redefining the traditional industries by improving human-machine interactions and enhancing data management and analytics. AI IoT (AIoT) will be widely applied in smart city (video surveillance), smart home and smart industrials, which will be the next driver for Hikvision (002415.SZ).
- **Automobile:** Supported by the advanced telecom technology and smart grid system, the trend of automobile will be 'Smart, Safe and Green' through the development of NEV (new energy vehicle) and automatic driving technology. By 2030, the penetration of NEV and ADAS (Advanced Driving Assistant System) cars will reach 40% and 17% respectively in China, benefiting the long-term growth of Sunny Optical (2382.HK), Hongfa (600885.SH), New Energy Material (002812.SZ) and Huayu Auto (600741.SH).

5. Replacing imported High-end technology products and services

The trade conflicts between US and China have alerted Chinese companies to build self-sufficient supply chain to cope with any potential disruptions of foreign suppliers. More opportunities are

open to local suppliers, who are supported by capital and their large clients to accelerate the technology development and gain experiences to climb up the learning curve.

In technology sector, China has accomplished import substitution of some components such as lens set, and the market share of domestic lens set has been improved from 30% to 70% in the past 10 years. Software and semiconductor components will follow the path and the leading local companies shall do very well. For example, SG Micro (300661.SZ), which is in analog integrated circuit design industry that overseas players dominate 90% of China market share, is expected to increase market share from current 0.6% to 4%. CCTC (300408.SZ), a company which is in advanced ceramic industry that foreign players account for over 90% of global market share, is expected to expand the market share from 0.8% now to 3%. Imported ERP has a market share over 70% in high-end China market today, we expect the domestic share of ERP to achieve over 80% in the next decade, and Yonyou (600588.SH) will benefit from this upcoming substitution trend.

6. Providing Information Technology (IT) services to businesses

Strengthened data analysis and management capabilities will create strong demands for IT operation services. Customers will realize the importance of after-sales maintenance and upgrades and they tend to be willing to pay for recurring high-quality services instead of making just one-time payment. The development of cloud computing also stimulates the transformation from one-time products to ongoing services and SaaS companies like Yonyou (600588.SH) and IT services company CS&S (354.HK) are going to generate higher portion of recurring revenue. The construction of IT systems for power grid will be the new driver of the grid investment and NARI (600406.SH), a software player in grid system, shall have opportunity to provide smart grid operation services to their clients.

Chart4: Our Theme

Consumption	Providing customized service with strong pricing power	
	<i>Pay for happiness</i>	Bilibili (BILI.O) Kuaishou (Planned IPO in 2020)
	<i>Pay for convenience</i>	S.F. Holding's (002352.SZ) Meituan Dianping (3690.HK) Oppein's (603833.SH)
	<i>Pay for alleviation of anxiety</i>	TAL (TAL.N) Aier Eye Hospital (300015.SZ) Bloomage Biotechnology (688363.SH)
	Benefiting from consumption growth in low tier cities	
	<i>Lower tier cities penetration</i>	Yili (600887.SH)
	<i>Consolidation</i>	Oppein(603833.SH) C&S Paper (002511.SZ) Huazhu (HTHT.O)
Manufacture	Improving supply chain efficiency	
	<i>Supply chain efficiency</i>	Pinduoduo (PDD.O) Alibaba (BABA.N)
	Building Information Technology infrastructure to boosts end user demand	
	<i>Smartphone</i>	Sunny Optical (2382.HK)
	<i>Wearables</i>	Luxshare (002475.SZ)
	<i>Internet of Things (IoT)</i>	Hikvision (002415.SZ)
	<i>Automobile</i>	Hongfa (600885.SH) New Energy Material (002812.SZ) Huayu Auto (600741.SH)
	Replacing imported High-end technology products and services	
	<i>Import substitution</i>	SG Micro (300661.SZ) CCTC (300408.SZ) Yonyou (600588.SH)
	Providing Information Technology (IT) services to businesses	
<i>Information Technology</i>	CS&S (354.HK) NARI (600406.SH)	

Source: Bin Yuan Capital

Portfolio Valuation

The All China portfolio of Bin Yuan gained by 33.14% in 2019, 18% contributed by earnings growth and 12.7% contributed by PE expansion, reversing the 26% of PE detraction in 2018. Even with the recovered multiple, the valuation level is still attractive at **xx PE**, lower range of historical band. We expect 18% annualized earnings growth of our holding in the next four years, and if we assume PE to keep flat, the expected return of the portfolio will be above annualized 15%.

Bin Yuan portfolio will stay mainly in the mid cap universe. The differentiation of our portfolio demonstrates the uniqueness of Bin Yuan’s investment style. The portfolio targets high quality professionally managed companies that have great potential to grow into dominant leaders in scalable industries. Most of these names are currently under-discovered Mid-caps but may become Large-caps in the future. The MSCI inclusion of Mid-cap A shares for the first-time in November 2019 will draw attention of international investors on those smaller but faster growing companies, which benefit our mid-cap focused portfolio in the long term.

Bin Yuan on the Road



December 2, 2019

We participated in the investor day for science and technology innovation board held by Shanghai Stock Exchange in Shanghai.

- We visited Amlogic, which is invested by HASCO (a leading auto parts supplier in China). HASCO is trying to move up value chain by investing in upstream semiconductor companies to improve competitiveness.

“Amlogic is developing SoC integrated circuit for CAR infotainment application and cooperating with HASCO and SAIC Motor.” – Board Secretary, Ms. Yu.



December 26, 2019

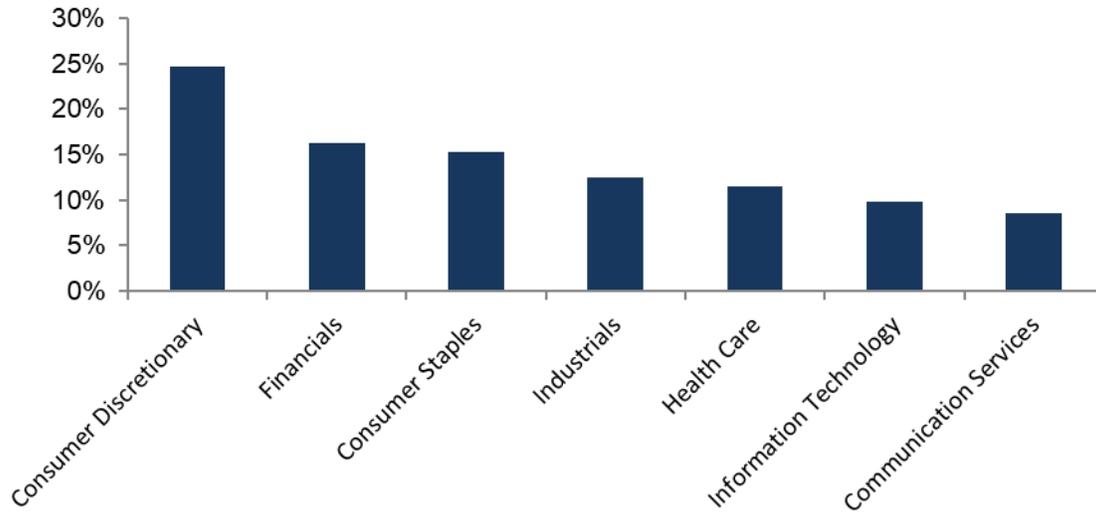
Cosmetic brand CHANDO and car brand Tesla announced partnership with Bilibili.

- The Generation Z consumers are valued by a lot of brands. As the average age of Bilibili's 120 million monthly active users is 22 years old, brands take Bilibili as the best channel to approach young people.

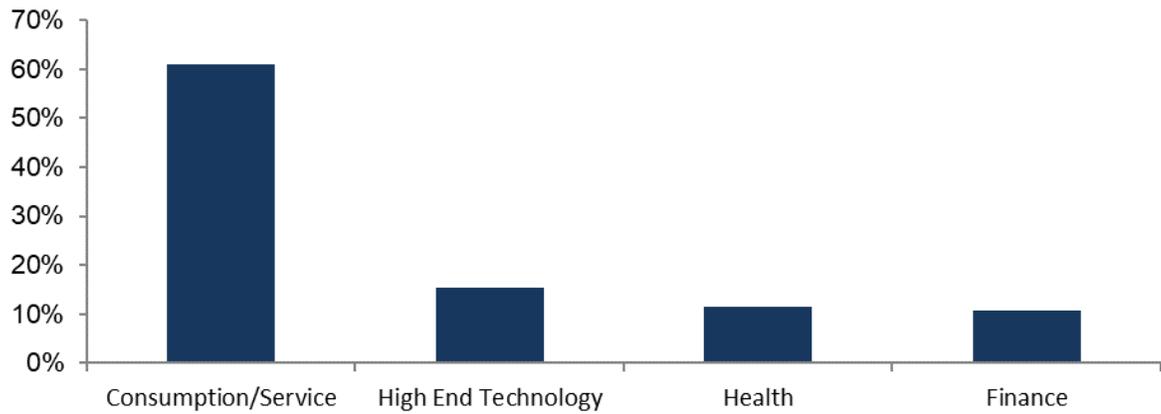
“Bilibili has a broad user base and unique product attributes. It has a strong synergy with us in cultural genes and user attributes.” – Wang Wenjia, Director of Product Engineering, Tesla.



By Sector Breakdown (Month-End):



By Theme Breakdown (Month-End):



By Exchange Exposure (Month-End):

Stock Market	%NAV
China A	54.7%
Hong Kong	31.3%
ADR	12.6%
Cash	1.4%

Sincerely,



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