Bin Yuan Capital All China Strategy – May 2020

Performance Attribution

In May 2020, Consumer Staples and Consumer Diecretionary sectors were the top contributors. Compared to the benchmark, Consumer Staples outperformed while Information Technology underperformed.

At the stock level, our long-term holding, a household tissue company continued to outperform in May due to that offline consumption activities are recovering. The company is also expanding to personal care products such as masks. We believe consumers will upgrade to products with good quality in the long term. Chinese household tissue industry is expected to increase steadily by around 10% every year. The company is the 4th largest household tissue manufacturer in China and is continuously increasing its market share. The company is the most innovative in developing new products, thus it enjoys the highest gross margin in the industry.

A medical instrument company unperformed in May due to the profit taking impact. As a high-value healthcare equipment manufacturer, the company's brand has been highly recognized during the COVID-19 outbreak, which will help it to expand to the overseas market in the next few years. From a long-term point of view, the company will benefit from aging population, upgrading consumption, and increasing medical equipment investment in China by providing a rich portfolio of products with good quality-to-price ratio.

Market Comments

The Chinese economy is showing signs of recovery. The Manufacturing Purchasing Managers Index (PMI) decreased from 50.8 in April to 50.6 in May while the Non-Manufacturing PMI rose from 53.2 in April to 53.6 in May, both stayed above the threshold of 50. Domestic excavator sales growth reached 64% YoY in April, up from 11% in March, showing infrastructure construction has resumed. On the consumption side, the decelerating trends narrowed. Passenger car sales dropped 2.5% YoY in April, reflecting a strong recovery compared to the 48% YoY decline seen in March. Home appliance sales growth recovered from a 30% YoY decrease in March to a 9% decrease in April. Smartphone sales increased 14.2% YoY in April, up from minus 23.3% YoY in March. As businesses actively expand their online channels, the number of express packages continued to grow steadily at 32% YoY in April, faster than the 23% YoY growth seen in March.

Two major events concerned the market during the month. On May 15th, the US government restricted Huawei's ability to use US technology and software to design and manufacture semiconductors, which caused a sell off of companies doing businesses with Huawei. As we have indicated in the past, the trade conflict with the US will push China to invest in upstream technology to prepare for the potential supply chain disruption. The import substitution progress in the high-end technology space will be further accelerated.

The second is the 13th National People's Congress that was held at the end of the month. The Congress has passed The National Security Law that applies to Hong Kong from May 28. This law, in accordance with the Basic Law of Hong Kong, targets acts of secession, subverting state power and organizing and carrying out terrorist activities. The move is aimed at protecting Hong Kong's social stability; however, some politicians believe that this change has altered the agreement of keeping the Hong Kong status quo that was agreed between China and the United Kingdom.

The 13th National People's Congress meeting gave priority to stabilizing employment and ensuring people's livelihood while the government has set no specific goals for economic growth this year. China will keep an open stance and focus on reforms that we believe are very positive. The following are the key points of focus in 2020:

- Stabilizing jobs:
  - Further reducing taxes and fees
  - Lower electricity prices, internet prices, and state-owned property rents
- Maintaining people's livelihood:
  - Strengthen the construction of the public health system
  - Pushing education equality and quality
  - Improve basic pension coverage and unemployment insurance
- Eradicating poverty:
  - Promoting the stable employment of migrant workers
  - Expand ways of employment and income for rural residents
- Expanding domestic market demand:
  - Support local services for the old
  - Expand consumption of rural residents
  - Increase basic infrastructure construction
- Strengthening reform:
  - Simplify company registration and operational procedures
  - State owned enterprise reform: strengthen mixed ownership, focus on core businesses
  - Push manufacturing sectors upgrade: increase loans for manufacturing businesses, develop industrial Internet, intelligent manufacturing, and digital economy
  - Strengthen intellectual property protection
- Continue the opening-up:
  - Support export companies to gain orders and stabilize employment
  - Expand import activity
  - Reduce negative list of foreign investment access
  - Accelerate the construction of Hainan free trade harbor
  - Promote trade and investment liberalization and facilitation

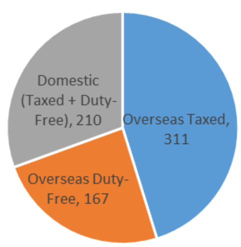
The establishment of Hainan Free Trade Port and related laws sends a strong signal to the "higher standard" of "opening-up". Chinese authorities on 1st June released a master plan for Hainan Free Trade Port, which shows China is aiming to establish a set of policies focusing on trade and investment facilitation across the whole island of Hainan by 2025, building an open economy by 2035 and a high level free trade port of global influence by midcentury.

Future economic growth in China will be mainly driven by consumption. China has the largest middle-class group in the world which will be the solid base of continued consumption upgrades. Additionally, there are more than 550 million rural residents and around 600 million residents living in third-tier cities and below. As the urbanization progress continues and big city lifestyles penetrate into lower tier cities, more consumption power will be released. Consistent with these trends, we have allocated 70% of our portfolio to consumption and service sectors. Duty-free retail, which will be driven by the increased level of opening up, is one of the long-term consumption opportunities. The accelerated development of duty-free consumption in China is discussed in the following section.

Example of Long-Term Opportunities - China's Duty-Free Retail Industry

Chinese consumers have a strong appetite for luxury goods. In 2019, luxury goods purchased by Chinese people worldwide reached RMB688 billion, of which only RMB210 billion (30%) were purchased in China. RMB167 billion were purchased in overseas duty-free stores with the balance in other overseas channels. (Chart 1)

Chart 1. Chinese Luxury Goods Consumption Amount by Location of Purchase (billion RMB)

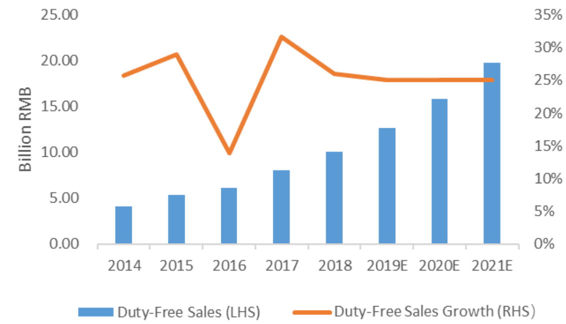


Source: Huatai Securities, Bin Yuan Capital

With current tax levels on imported luxury goods, duty-free channels are very price competitive. For example, imported luxury cosmetics are charged a 10-18% tariff, 30% excise tax and 16% value added tax. The demand for duty-free products is very strong, as reflected in sales of overseas duty-free channels. With more openings of domestic duty-free stores and the release of Hainan offshore duty-free policies, buying duty-free goods in China has become easier and more convenient. The huge overseas spending flowing back to China keeps supporting the fast growth of domestic duty-free retailers. In 2020, due to the COVID-19 epidemic, people will not be able to leave the country, and are more actively looking for domestic duty-free channels such as Hainan offshore and in-city stores.

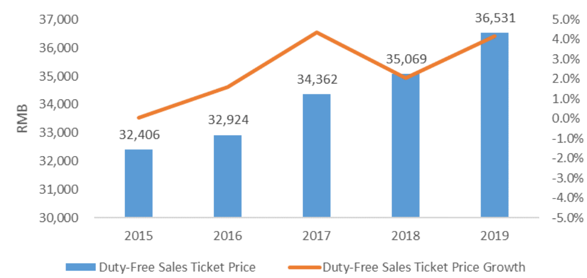
In 2019 domestic duty-free sales were around RMB12 billion, after seeing an annual compound growth rate of 25% over the last 3 years (Chart 2), driven by the increase of traffic, conversion rate and ticket price (Chart 3).

Chart 2. Duty-Free Sales and Growth in China



Source: Wind, Bin Yuan Capital

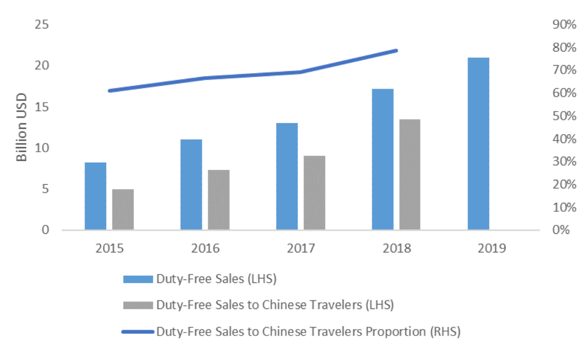
Chart 3. Duty-Free Sales Ticket Price and Growth



Source: Wind, Bin Yuan Capital

In 2018, duty-free sales were USD17.2 billion in Korea, of which USD13.5 billion were purchased by Chinese travelers, representing 78% of total sales (Chart 4). Chinese people's duty-free consumption in Korea was 8 times larger than the duty-free consumption in China, which shows a huge potential for the Chinese duty-free retailers.

Chart 4. Duty-Free Sales in Korea and Proportion Sold to Chinese Travelers

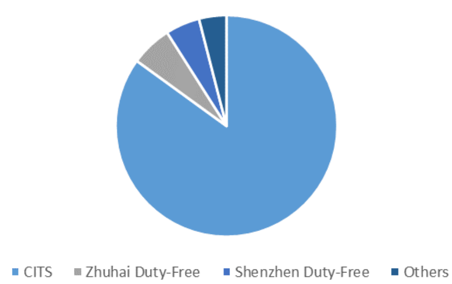


Source: Korean Duty-Free Association, Huatai Securities, Bin Yuan Capital

Who Will Benefit from This Trend?

Currently, China's duty-free retail industry follows the license authorization mechanism. New duty-free shops need to obtain approval and operational licenses from the Ministry of Finance of the State Council. Until now, there are only four state owned operators, China International Travel Service (CITS), Shenzhen Duty-Free, Zhuhai Duty-Free and China National Service Company (CNSC). After consolidating Sunrise Duty Free Shop in 2018 and Hainan Duty Free Shop in 2019, CITS has become the dominant player in the industry, with 85% of market share in China (Chart 5). The Hainan offshore duty-free market, which was affected by the COVID 19 has seen a quick recovery, and CITS has 100% market share there after the acquisition of Hainan Duty-Free Group. It is clear that CITS will be the biggest beneficiary in China's duty-free retail industry.

Chart 5. Market Share of Leading Duty-Free Groups in China

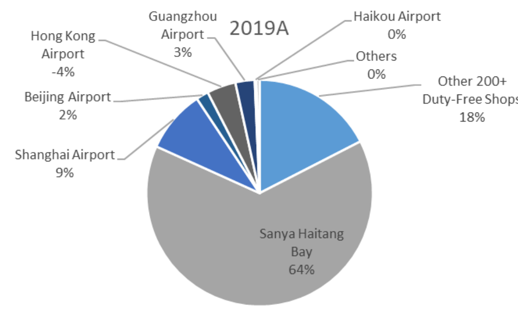


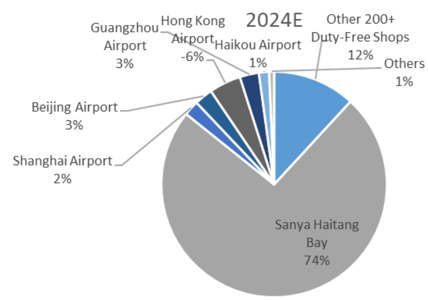
Source: Public Information, Bin Yuan Capital

Future Growth Drivers of CITS

By 2019, CITS's duty-free retail channels are mainly at cross-border entrances (airport shops) and Hainan (offshore duty-free stores). Hainan's stores contributed 64% of CITS's profit in 2019 due to high net profit margins and will continue to drive its growth in the future (Chart 6).

Chart 6. Net Income Mix of CITS





Source: CITS Annual Report, Bin Yuan Capital

Revenue in Hainan will be driven by the following:

- Fast growing travelers - as Hainan is positioned as an International Travel Island and Free Trade Island

Positioning Hainan as an international travel island was first raised in 2000, then emphasized in 2010 with plans on infrastructure, travel policies and duty-free trading. Haikou is positioned as the transportation center of the island with responsibility for organizing meetings and exhibitions, while Sanya is focused on travel and leisure services, having several new amusement parks and resorts attracting millions of travelers every year. In 2018 President Xi pointed out that Hainan island is to be positioned as a free-trade port island. It can be expected that travelers to Hainan island will grow rapidly in the future.

- The rise of penetration rate in Hainan travelers

CITS's Sanya duty-free plaza phase II opened in January 2020, and its Haikou duty-free plaza phase I is scheduled to open in 2022. We expect that as the surrounding exhibition centers, hotels, resorts, scenic spots, and other facilities are further improved, CITS's stores will attract further passenger flow and thus increase duty-free sales.

- More Policy Support for Hainan Offshore Duty-Free Retail

The Chinese government has shown determination to boost Hainan's duty-free industry, which served as a cushion to absorb the COVID-19 impact on tourism related industries. Since 2010, Hainan has enjoyed various policies to further opening up its duty-free retail industry. On 22nd March, Hainan's provincial government announced a RMB150 million (US$21.2 million) rejuvenation plan for the island's tourism industry with duty-free shopping at the heart of its plans. On June 1, the duty-free quota was raised to RMB100,000 from RMB30,000 per person per year. More policies are expected to support Hainan's duty-free retail industry.

Table 1. Continued Upgrade of Hainan Duty-Free Policies.

Time of Issuance	Policy Key Points
Mar-11	Quota RMB5,000 Age limit: above 18
Oct-12	Quota: RMB8,000 Age limit: above 16
Jan-14	"Buy first, tax refund later" trial in Sanya
Feb-15	Quota: increase item limits
Jan-16	Quota: RMB16,000 Online shopping opened
Dec-18	Quota: RMB30,000
Jun-20	Quota: RMB100,000

Source: Department of Commerce, Bin Yuan Capital

Besides Hainan, CITS is also expected to expand by opening more in-city stores. CITS has currently opened 5 in-city stores in Shanghai, Beijing, Xiamen, Qingdao and Dalian. Compared to airport stores, in-city stores have a greater number of products and provide better customer service. Currently in-city stores are open to foreigners only, but we expect that the Chinese government will follow Korea's experience soon and allow Chinese consumers to shop at in-city duty-free shops before going abroad. This is an additional huge growth potential for CITS.

Conclusion

With 85% market share in the highly regulated Chinese duty-free market, CITS is the market leader and can maintain its position in the foreseeable future. The company takes care of interests of public shareholders proved by track records. For example, when the holding company injected the duty-free store assets into CITS, the price was reasonable and actually favorable to minority shareholders. By leveraging its license advantage, significant bargaining power over suppliers, the most dynamic and efficient operations team, and exposure to Hainan, CITS is certain to benefit most from fast growing duty-free consumption market in China.

Sincerely,

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Bin Yuan on the Road

May 07, 2020

One customer used CITS online store and bought taxed goods.

- The goods sold in the online store are the same as those sold in the offline stores, but they are mailed to consumers after the relevant taxes are paid by CITS, so consumers are not required to provide outbound exit records. This is a new business that CITS vigorously developed during the epidemic.

"Even after tax, the goods are still at 70% of normal prices in shopping malls." – *A customer.*

May 14, 2020

Yuyue launched a public service activity by providing small packages of disinfection products in elevators.

- Yuyue's disinfection product has been highly recognized in hospitals during the COVID-19 outbreak. Company is launching new products to address the civil market.

"It is very convenient to use this product in the elevator." – An elevator passenger.

May 15, 2020

Pinduoduo start to set foot on the local service market.

- Burger King has cooperated with Pinduoduo to open an official store, where users can purchase coupons for offline consumption. This marks a new trial for Pinduoduo to expand its businesses.

"We are very optimistic of E-commerce industry, and there are still a lot of offline consumption scenarios that can be transferred online." – Bin Yuan Analyst.