

## Bin Yuan Capital All China Strategy – Second Quarter 2020

### Performance Attribution

In the second quarter of 2020, Consumer Discretionary and Communication Services were the top contributors. Compared to the benchmark, Consumer Discretionary outperformed while Health Care underperformed.

At the stock level, a comics and games platform outperformed in Q2 2020. Because of COVID-2019, the demand for home entertainment rose rapidly and the company has accelerated the speed of acquiring users and cultivated the habits of new users. The continuous enrichment of content has made the company gradually grow into a mainstream video platform, and its users gradually regard it as an indispensable entertainment method. We believe that it will continue to be the favorite entertainment community in China.

A funeral service company underperformed in the second quarter. Although the company's short-term performance is lower than expected due to the epidemic impact, we still believe that the company has long-term investment value. The company's main business is funeral service which is a rigid demand. On the one hand, with the increase in number of aged people, the demand for funeral services will continue to grow. On the other hand, the market has started to expand to value-added services such as valet tomb-sweeping services, which will improve the company's profitability. China's funeral industry is very fragmented, and the company is constantly gaining market share through excellent management and sufficient capital.

### Market Comments

The epidemic is now eased in China after the small scale of COVID-19 outbreak in Beijing in June. Total 325 people in Beijing were tested positive by June 29,

and the local government acted quickly to chase the close contacts. As of June 30, 7.687 million novel coronavirus tests have been completed, and all contacts of confirmed cases have been tested in Beijing. Since July 7, no new local case was reported. The high alert level and the experience dealing with the pandemic has made the situation under control. However, we should not expect the virus to disappear soon. The control of the mobility of people and the economy growth still need to be balanced.

China's economic recovery continued in the second quarter. Electricity generation, which is a sign of the economy dynamics in China, rose by 4.3% YoY in May, up from 0.3% YoY in April. The industrial output also expanded by 4.4% YoY in the current month. Excavator sales remained a high YoY growth of 68%, indicating strong construction needs. Domestic consumption power remained strong. Parcel numbers, which reflected the performance of the E-commerce, hit 7.4 billion with a 41% YoY growth in May, averagely each person in China received 5.28 parcels. The growth of household air-conditioner installations YoY growth turned positive for the first 5 months of 2020, which is actually quite good considering the COVID-19 epidemic impacted the installation a lot.

Two major events concerned the market during the quarter. 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 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.

Opening-up remains an unchanged theme. 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.

## *Bin Yuan Opinion*

### **Value Proposition and Investment Opportunities – Digital Transformation**

To help clients understand Bin Yuan's investment positioning, we have divided our investment exposure into three segments. The different segments are based on company's growth stages: stable growth, upcycle growth and the new economy. The new economy segment refers to those companies that have emerged from the information digital era featuring light tangible assets and limited profitability at the early stage of their operations, which makes it difficult to price them using traditional tangible asset-based methodologies. As the new economy getting more and more important in Chinese society, we believe it is necessary to illustrate our analysis and lay out the investment rationale.

The definition and approach of value investing have been debated and the unsatisfactory investment results by traditional value investors in recent years have made many re-evaluate what is the value of a company. We have reviewed and studied value characteristics in different economic development stages from agricultural (land and rents), industrial (machine and products), and to the current information (people and architecture) era. A typical industrial stage firm reaches \$300 billion market cap and faces growth bottlenecks and monopoly regulations, yet an information-based firm can reach \$1 trillion market cap within a much shorter period and will not show signs of its cycle peaking. We think that intangible value (human knowledge not bookkeeping) has increased over time as a proportion of a firm's total value. This phenomenon is causing two consequences: firstly that it has made traditional tangible asset based value investors dizzy, and secondly that it requires significant analytical skill changes for investors to understand the increasingly high proportion of intangible assets of an organization.

In this letter, we will briefly illustrate some basic analysis on the characteristics and business models in different economic development stages (Please refer to Table 1). Trying to be as objective as possible, we have tried to list as many characteristics as possible for this analysis. We found that the following phenomenon had emerged, which altered the form of game. The leading companies in the digital informational era are far more scalable than those in the industrial era. It has revolutionized the speed of information, the collection and the use of data, the concept of barriers to entry, the boundaries of business and products, and in the end, the lifestyle of people.

Table 1. Comparison of three eras

	Agricultural	Industrial	Informational/Digital
Characteristics	Long Cycle Low Value-Added Labor Productivity Very Low Growth Family Attribute Clan/Nobility owned Trust Built on Kinship	Accelerated Cycle Medium Value-Added Technology Productivity Linear Growth Business Attribute IP Trust Built on Brand	Quick Cycle High Value-Added Data Productivity Exponential Growth Social Attribute Sharing Trust Built on Platform
Business Model	Labor Handcraft One-on-one Channel Single Work Process No Operating Leverage No Cross-Boundary Innovation on Tools	Capitalist Engineers Centralized Channel Cooperation of Upstream and Downstream Low Operating Leverage Product/Channel Cross-Boundary Patent Monopoly Innovation on Products	Service Providers Architects Distributed Channel Platforms High Operating Leverage Service/Demand Cross-Boundary Platform Monopoly Innovation on Business Models

To summarize the analysis, there are at least four unique features of the new economy that enable a firm to reach critical mass and operate successfully:

1. *The social attributes of the digital economy help companies to penetrate to a much broader scope of social relationships and activities:* Instead of providing physical products and tangible services, informational companies mostly provide intangible and invisible services. It provides a platform that enhances social relationships and activities among business to business, business to people and people to people. In the industrial era, trust is built on direct contacts. In the information era, Artificial Intelligence and Big Data have improved the trust, which makes social and

business relationship, including the breadth, speed and frequency of reaching people, much more efficient than the past and thus, significantly increased business activities.

2. *The demand focused structure:* consumer demand will become more diversified, more customized, and change more frequently. Digitalization facilitates the precise matching of demands with vendors including even long tail demand. The demand focused structure will move towards distributed and decentralized patterns, which makes information dissemination more effective and enlarges the whole universe of demand that could be serviced.
  3. *The blurred supply boundaries:* Information technology innovation has debottlenecked the supply chain. New players are breaking the industrial period's boundaries to service the needs of users. The biggest barrier is no longer technology at the supply side, but the business architecture and ecosystem needed to meet the demand. Instead of achieving a monopoly by relying on IP (Intellectual Property) in the industrial stage, the sharing nature of the information stage increases the importance of platform architecture, which is the key success factor to obtain a monopoly in the new era.
  4. *High operating leverage:* The digital business model by its very nature has minimal marginal costs. The cost of servicing one new user is very low. Achieving scale of users and data is critical. Those companies with a high level of operating leverage can become platform monopolies.
- Our investment approach in identifying digital company value focuses on the following metrics:

1. *Value of users:* The growth of active users and the long-term potential value generated by those users are most important to assess the value of the

company. A large number of users can feed the iteration of products.

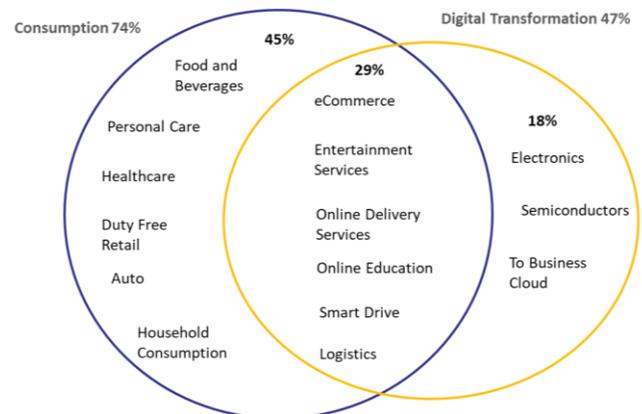
2. A proven architecture design: The digital service platform is essentially an architecture design. The value of the business architecture includes the way of defining company vision, organizing human resources, allocating capital, and acquiring and keeping users on the platform. A well-designed architecture is a high barrier to entry.
3. The designer mindset and execution capability of key personnel: The architecture nature of the business makes the top leaders of the information stage firms have totally different skill sets compared to industrial time leaders whose capability was product based. The key person of informational companies is an “architect”. The skill is not transferable. The key person’s talent to design and build the platform is the most valuable within a company.
4. The stage of growth cycle: Our mid cap investment focus is investing in a firm that is at the middle of its growth cycle. These companies have completed their early stage of development and built a critical mass of users on their platform. A company at this stage is ready to move into the next stage of rapid growth and barriers to entry are high for competitors. Winners in the digital era have much less business bottlenecks than the ones in the industrial era. That is why a company with a market cap of \$100 billion would be perceived as a large cap stock in the industrial area but could be viewed as a mid-cap stock in the informational area.
5. New risks: The risks in the informational era are also different compared to the industrial era. The risks may include losing key personnel, new competition from cross boundary players, data

privacy and security, and the risk of less well-designed architecture.

We believe that digitalization in the information era will significantly lift productivity, change peoples’ lifestyles, and generate enormous value over the next decades. The US and China will be the dominant leaders and largest beneficiaries. China which has the most efficient manufacturing supply chain, the largest group of software engineers, a well-established consumer market, is perfectly positioned to lead the digitalization society. The scale of the digital economy in China is estimated to hit RMB 35 trillion in 2019 which is equal to 35.4% of total GDP. It is a China investment theme that an investor should not miss for the next decade.

47% of our portfolio is directly or indirectly associated with the trend of digital transformation (Chart 1), including both internet/software companies and industrial/hardware companies. Mobility will be shifted from offline to online. Remote working, online services such as shopping, medical consultation and online education based on mobile platforms will continue to spring up. Infrastructure of digitalization, namely cloud investment, will pave the way for the digital applications. More details of digitalization infrastructure will be discussed in future newsletters.

Chart 1. Portfolio Positioning by Theme



Sincerely,



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## Bin Yuan Engagement

July 07, 2020



**S.F. Holding released its first-ever Annual ESG Report in according to Bin Yuan's suggestion.**

- In China, the concept of sustainable development is getting more and more attention and recognition. As a firm practitioner of responsible investment, we are committed to helping listed companies improve the level of ESG governance and information disclosure. With our continuous engagement efforts, S.F. Holding has recently released its annual report on sustainable development in Chinese and English for 2019. We believe that with the improvement of market regulations and the joint efforts of investors, China's ESG governance and investment environment will continue to be optimized and improved.

*"We continue to pursue high level of sustainable development and are open to more discussions on disclosure in the future."*

– S.F. Holding, Investor Relations.

## Bin Yuan on the Road

June 18, 2020



**We attend Venus's (a transcatheter heart valve manufacturer) online seminar in 2020 Cooperation Innovation Transition (CIT) conference meeting.**

- Transcatheter valve replacement is an emerging treatment to the valvular heart disease, which causes smaller trauma and has a shorter postoperative recovery period. Since local healthcare equipment suppliers' breakthrough in transcatheter valve technologies, China market is expected to achieve a 65% CAGR growth in the next 5 years.

*"The 2nd generation product is easier to operate and has better performance than last one."* – President Wang, from The Second Affiliated Hospital of Zhejiang University School of Medicine.



June 15, 2020

**We investigated Lynk&Co (a car brand under Geely) 4S store in downtown Shanghai and communicated with sales staff and consumers.**

- With the alleviation of the epidemic situation, the consumption of residents gradually recovered. As an independent high-end automobile brand, Lynk&Co automobile has successfully combined Volvo's technology and widely attracted customer attention.

*"Lynk&Co series, supported by Volvo technology, is more affordable than the joint venture brand, and has more cost-effective advantages."* – A customer.



**April 30, 2020**

**One of our analysts visited Sanya Haitang Bay Duty-Free Store.**

- Sanya Haitang Bay duty-free store has recovered 50% of customer flow. Retail stores has set traffic limits and customers are still very eager to do shopping there. The duty-free business in Hainan will continue to drive the growth of China International Travel Service in the long term.

*“Due to the epidemic, we choose to visit Hainan island instead of traveling abroad. It is very convenient that we can buy duty-free products in Hainan.” – 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.*