Bin Yuan Capital All China Strategy – January 2024

Performance Attribution

After a short rebound in December, the China equity market had a horrible January characterized by panic selling. A few factors were behind the market drop. Some foreign active funds took advantage of the December rebound and sold US$2.5 billion in January, but still less than the average monthly net outflows of over US$3 billion in Q4 2023. The more critical factor was redemptions by local funds as many investors lost patience with the market. The average return of active long-only local funds in 2023 was negative 20+% and negative 40+% over two years. The market decline triggered further selling by margin calls and forced liquidation of those structured products and funds that launched in early 2021 with a three-year lock-up period with NAV losses exceeding 60%.

To prevent further stock market turmoil, government funds (Stabilizing Funds) intervened to support the market by purchasing large index stocks and ETFs that were mainly composed of SOEs (large-cap State-Owned Enterprises). As a result, the large-cap indices dropped less than the broad market with the SSE Composite Index, SSE 50 Index, and CSI 300 down only 6.3%, 3.1% and 6.3%, respectively. However, the mid- and small-cap universe saw the ChiNex Index and CSI 2000 dropping by 16.8% and 21% which were their most substantial monthly drawdowns since 2016.

With our focus on quality mid-caps, our holdings did not benefit from the government intervention, and our portfolio declined 15.26%, trailing the index by 5.32%.

At the stock level, China Merchants Bank (CMB) outperformed in January with the market supporting large cap high dividend sectors with government stakes. The cut to the Reserve Requirement has contributed to confidence in the financial sector. CMB has been trading at a multi-year low PE of below 5X and a PB of around 0.8. The dividend yield is expected to be 6.2% in 2023. CMB is the No.1 retail bank in China with established, sophisticated governance policies and systems, and will be a long-term beneficiary of a return of consumer confidence.

iRay Technology underperformed in January due to profit taking after the Q4 rally. The company should gain momentum in 2024. iRay's products are key components for medical image clarity and industrial inspection accuracy. Upgraded products and a more comprehensive product offering are expected to bolster growth in 2024. The trend of import substitution in the domestic market with product expansion in dental, industrial and non-detector products, and breakthroughs in overseas markets should continue to act as long-term growth drivers.

Bin Yuan Comments

We believe that the panic selling this month is close to the end. It is possible that the margin calls and fund redemptions are not totally completed, but the scale of the liquidation should be reduced as most of the damage was done at the end of January. We strongly advise our investors to stay in the market because, according to our experience, any marginally positive changes should bring a very good market rebound as Chinese stocks are oversold and very cheap; the only thing left is investors' confidence.

The government strongly intends to support the stock market to boost confidence in the financial markets. In addition to providing Stabilizing Funds, and injecting liquidity into the economy by cutting the bank Reserve Requirement Ratio by 50bps, the following policies were adopted to support the economy and the market:

1. For the property sector, the government a) provides financial support to the fragile property sector. It requested banks to continue their current lending programs to developers to complete in-progress projects; b) granted rights to local governments to remove some of the home purchase restrictions in higher-tier cities to ease the sharp impact of the bursting of the property bubble; c) cut 25bps off the re-finance mortgage rate and lowered the downpayment ratio to improve affordability. A further interest rate cut is highly possible.

2. The stock exchange regulators will take more measures to improve sentiment, such as curbing any business activities and behavior that may hurt shareholder interests, cracking down on fraud, encouraging dividend paying, etc.

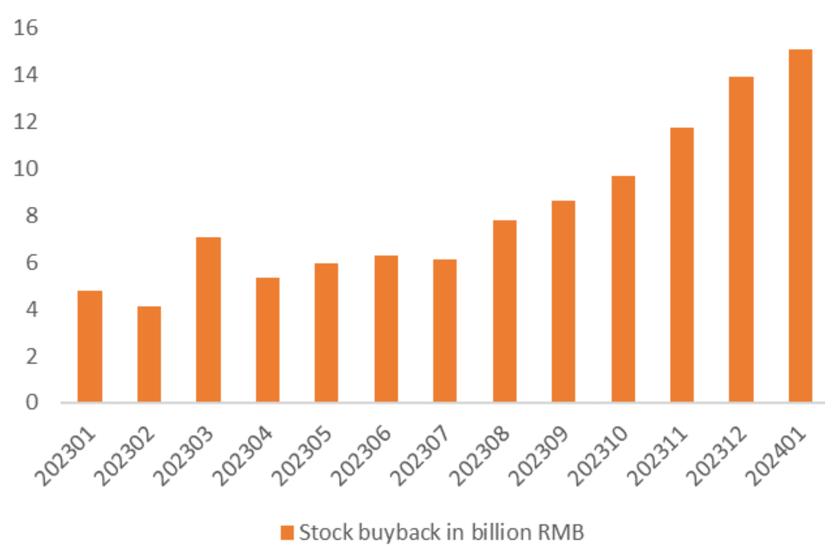
3. China announced that foreign intuitions could own 100% of a China finance business. Even though this has taken too long to implement, it is still an indication of the government's willingness to open up the country's financial markets.

We also see less negative trends or catalysts in the market:

1. The intensity of foreign selling pressure has eased, as active fund outflows in January 2024 saw a 17% reduction compared to the fourth-quarter average. Margin calls and redemptions are close to the end.

2. Share buybacks from listed companies have been increasing. The buyback value in January 2024 has more than tripled to over RMB15 billion from less than RMB5 billion in January 2023 (Chart 1). For our holdings, 22 companies have bought back shares in the past three months, and 16 are doing so or will do so in the months ahead. We do not expect these moves to bolster stock prices quickly, but this will provide support and boost confidence.

Chart 1: China A Share Market Buy Back Amount



Source: Bin Yuan Capital, iFinD

As we navigate through the final phase of panic selling, we anticipate an enhancement in market and economic confidence stemming from the potential stimulus and catalysts mentioned above. In the short-term, large cap stocks are outperforming, benefiting from the moves of the stabilizing fund. But in the long run, oversold high quality companies with good growth, stable cash flows and cheap valuations will deliver much more alpha.

17 of our portfolio companies have announced their preliminary earnings results range or positive warnings as of the end of January, all meeting or exceeding our expectations, with over 30% surpassing consensus estimates.

After the January drop, our portfolio sells on a forward PE of 10.7x (Harmonic method) and we project annual earnings growth of 20% plus over the next three years.

As time progresses, fundamental factors will inevitably become increasingly significant in shaping market dynamics and companies valuations.

Quoting Jeremy Grantham's insightful observation from his March 2009 newsletter during the global financial crisis, "…the market does not turn when it sees light at the end of the tunnel. It turns when all looks black, but just a subtle shade less black than the day before." From a long-term perspective, we firmly believe that this is precisely that moment.

Bin Yuan Opinion

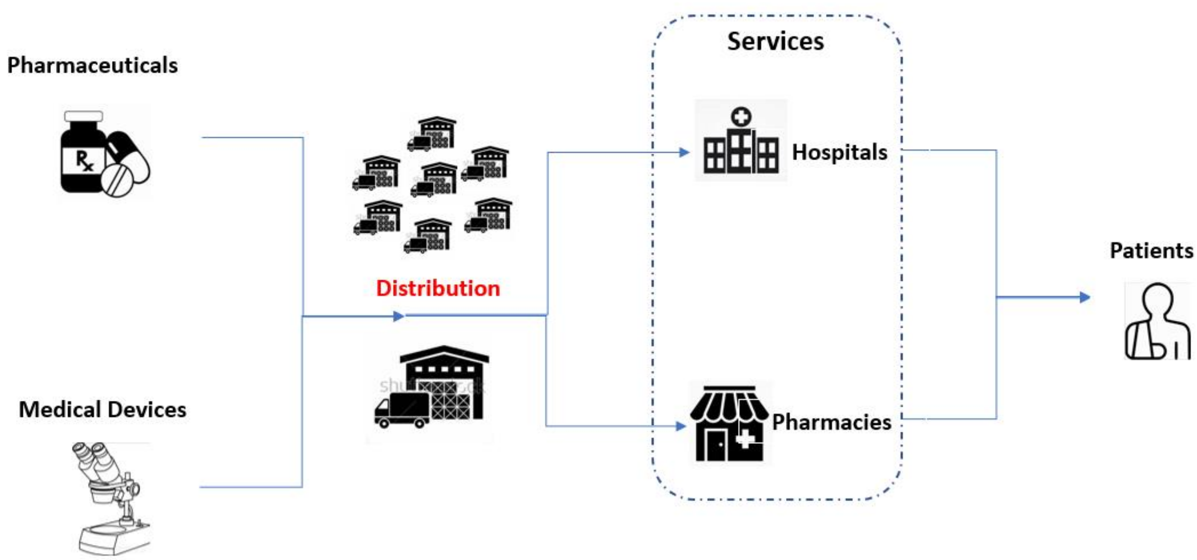
Sinopharm – Beneficiary of Consolidation among Medical Distributors

Medical distributors serve as essential links, ensuring that pharmaceuticals and medical devices are delivered from manufacturers to services providers like hospitals and pharmacies, and ultimately to patients. China's vast geography and layered administrative structure have historically led to a fragmented distribution network with multiple distributors operating across different regions, each adding extra costs to the supply chain (Chart 1).

Since 2017, China's "two-invoice" policy has streamlined the pharmaceutical distribution landscape, reducing the previous multi-layered system to a simpler model involving just two invoices: one from pharmaceutical companies to primary distributors, and another from distributors to the hospitals. This initiative aims to cut down the number of intermediaries, thereby decreasing the overall costs associated with drug distribution.

Initially, the industry, composed of numerous small- and medium-sized distributors, struggled with this new policy. However, from 2019 onwards, a series of regulatory measures have solidified channel consolidation as a definitive trend, gradually reshaping the distribution landscape towards greater efficiency and fewer intermediaries.

Chart 1: Value chain in Healthcare



Volume-based Procurement Policy of Pharmaceuticals forced distribution consolidation

The volume-based procurement policy of pharmaceuticals initiated in 2019 has greatly impacted the industry, leading to a significant reduction in profit margins. This has compelled pharmaceutical companies to reduce costs, thereby limiting opportunities for smaller distributors. As a result, there has been a shift towards larger distribution firms, minimizing intermediaries. This trend is reflected in the increase of the market concentration ratio for the top five companies (CR5) from 24% in 2016 to 43% by 2022 (Chart 2 & Chart 3).

Chart 2: 2016 China medical distribution market share

Top 5 Market Share: 24%

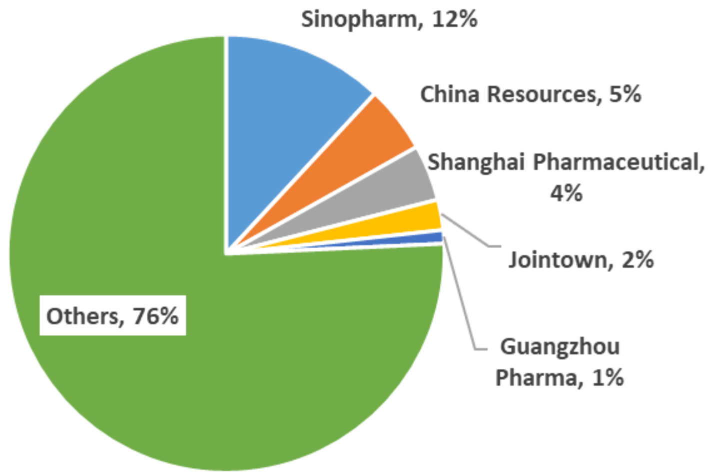
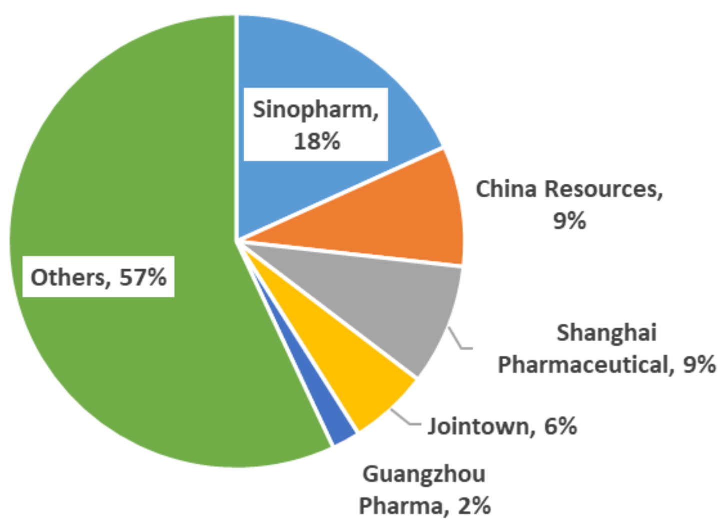


Chart 3: 2022 China medical distribution market share

Top 5 Market Share: 43%



Source: Company Annual reports, iFIND, Bin Yuan Capital

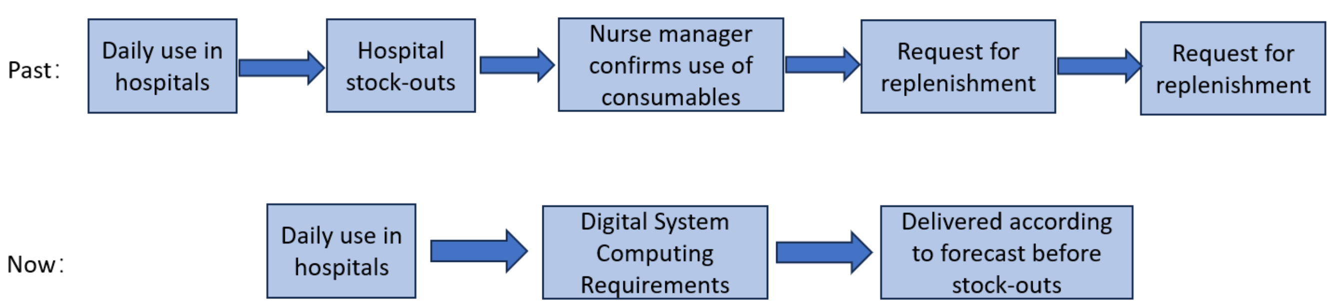
SPD Model is optimizing medical devices channel

The volume-based procurement policy of medical devices was initiated in 2021. Considering both cost and efficiency, the Supply, Processing, and Distribution (SPD) model for medical consumables has gained development opportunities. The SPD model involves a hospital outsourcing the entire business of medical consumables to a distribution company, rather than negotiating prices with numerous suppliers and distributors. The distribution supplier, through information technology, intelligent construction, and operational process optimization, establishes a smart supply chain management platform for medical consumables, assisting hospitals in achieving refined management. Given the wide variety of medical consumable specifications, this one-stop service is beyond the capabilities of small distributors.

Under the traditional circulation model, hospital staff not only spent a considerable amount of time communicating with various suppliers and distributors but also invested significant time in product inventory and replenishment during the specific usage process. This led to the consumption of substantial manpower, potentially impacting the efficiency of medical work (Chart 4).

Large medical distribution companies offer the SPD model to help alleviate these issues. They offer comprehensive services and integrated systems, helping hospitals reduce their workload and communication costs. With the assistance of large medical distribution companies, hospitals can free themselves from the burdens of logistics and warehouse management, allowing them to focus more on medical and research activities. For example, a top-tier hospital in Shanghai's Changning District, after partnering with Sinopharm Group, no longer required a 200-square-meter primary warehouse. The warehouse is now used as a new healthcare department. The hospital also reduced the workload of pharmacists by using digital management, decreasing the work time for the head nurse in this area by 97%. Additionally, manual billing for consumables was reduced, ensuring consistency in procurement and charges.

Chart 4: SPD model vs traditional circulation model



Source: Bin Yuan Capital

In addition to saving on warehouse costs and working hours, large medical distribution companies also contribute to lower product purchasing costs. All procurement information is compared online, and when a distribution company identifies that a hospital is paying significantly more for a particular product compared to other hospitals, the distributor contacts the supplier to understand the reasons and assists the hospital in obtaining a more reasonable price.

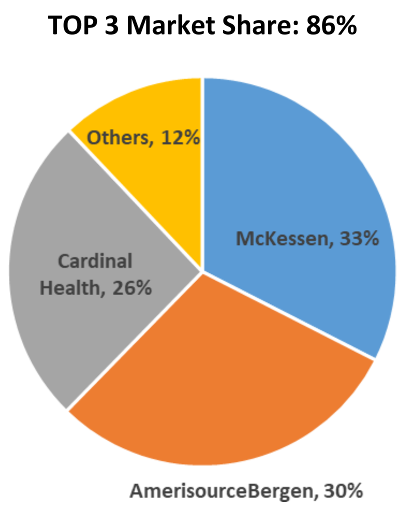
From 2019 to 2021, the number of SPD projects in China rapidly increased from 32 to 488, with a compound annual growth rate of 140%, reflecting a significant jump in penetration rates from 0.2% to 3.6%. We expect that the SPD model will be increasingly adopted by more hospitals and channels.

Compliance is also a driver for channel consolidation

Amid China's intensified anti-corruption efforts in the medical sector since August 2023, many local distributors reliant on hospital connections have been phased out. This has led hospitals to prioritize partnerships with medical distribution firms that can ensure compliance, further bolstering the adoption of the SPD model. Hospitals previously hesitant about the SPD model are now actively seeking collaboration with reputable distribution companies to align with compliance standards and mitigate corruption risks.

Looking ahead, we expect that hospitals will increasingly prefer partnerships with major medical distribution firms. The trend in China's medical distribution concentration ratio (CR5), which was at 43% in 2022, is anticipated to rise significantly, potentially reaching 75% over the next decade, supported by strong domestic policies and the growth of large distribution companies. This projection is in line with trends seen in other markets, such as the United States, where the CR3 already stands at 86%, indicating a global move towards more consolidation of medical distribution channels (Chart 5).

Chart 5: USA medical distribution market share



Source: Bin Yuan Capital

Sinopharm Group (1099.HK) – Beneficiary of medical distribution consolidation

Sinopharm Group, with an 18% market share, stands as the leading medical distributor in China. It has expanded its centralized distribution and SPD projects, now spanning 28 provinces and adding 50 new SPD projects in just the first half of 2023. Particularly in major areas like Shanghai, the Group's SPD division has successfully connected with over 90% of top-tier hospitals, positioning Sinopharm to benefit greatly from the ongoing expansion of SPD infrastructure.

We believe **Sinopharm Group** is strategically positioned to expand its market share by capitalizing on policy reforms and its inherent strengths. The company is on track to reinforce its status as a leading entity in the medical distribution sector, offering a wide array of capabilities. We forecast that the revenue of **Sinopharm Group** will reach RMB88 billion on its intrinsic growth and the net income will be RMB 12.4 billion in 2026. The annualized intrinsic growth rate from 2023 to 2026 is forecasted to reach 10.8%. Considering its 4.3% stable dividend yield, if applying 10X PE, the company should see 114% upside by 2026.

Sincerely,

Ping and the Team

February 7, 2024

Bin Yuan on the Road

January 9, 2024

We visited trip.com group, a leading online travel platform, to further understand/discuss the travel rebound in 2024.

Their domestic business was strong due to increased online reservation penetration in the hotel business. Outbound travel has recovered to 60% of 2019 levels. Trip.com has led the recovery in the industry. Besides domestic and outbound travel, that mainly service Chinese travelers, the company's international business is also expecting satisfying growth and improved margins. We remain positive on the travel industry and the increased competitiveness of trip.com.

" The Chinese travel industry is expected to continue the growth trend in 2024, and trip.com is a beneficiary in the increased online reservation penetration." – Trip.com's Head of Investor Relations

January 14,2024

We visited Spring Airlines, a domestic airline in Shanghai, and met with Investor Relation Director Mr. Xu to crosscheck outbound flights supply and demand.

As aviation capacity gradually recovers, the number of international flights into China has recovered to 65% of the pre-pandemic level. According to the Civil Aviation Administration of China's plan, this is expected to further increase to over 80% in 2024 to meet the growing demand among Chinese citizens for overseas business and tourism. This recovery in capacity is anticipated to drive rapid growth across the entire aviation industry.

"The current bottleneck for the company primarily resides in our production capacity, including both airplanes and pilots. However, we anticipate this gap will close swiftly in 2024. Coupled with China's further easing of visa restrictions, we are confident in the industry's rapid recovery in the coming year." – Mr. Xu stated.

January 29, 2024

We attended 2024 Arab Health Convention in the UAE

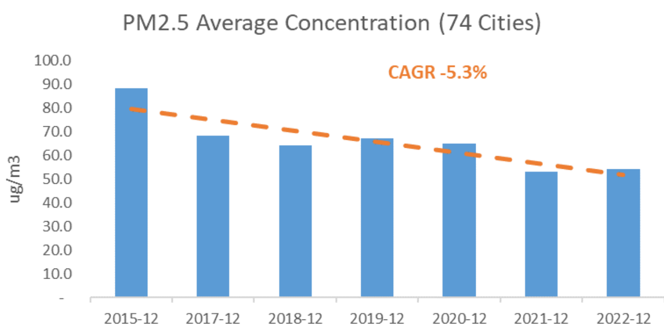
We were pleased to see a large number of Chinese companies at the event, including listed companies in which we are interested, and many small- and medium-sized Chinese innovators. Chinese companies attach great importance to the Middle East market and have show cased their cutting-edge products, attracting many local customers. It is worth keeping an eye on the future development of various medical device companies in the Middle East.

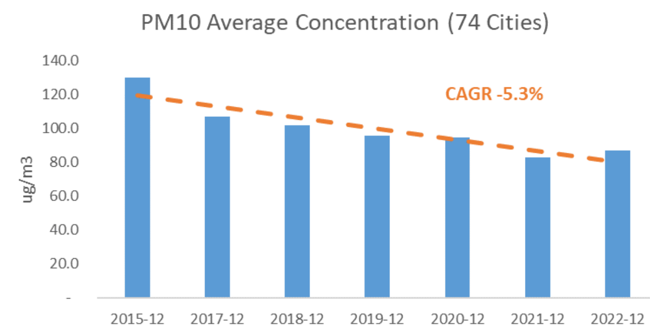
" The Middle East is our key development area. The new incremental volume of respirators in the UAE is 2,000 units per year, and BMC (a leading Chinese ventilator player) accounts for about 10-15% of that." – BMC medical staff at the exhibition.

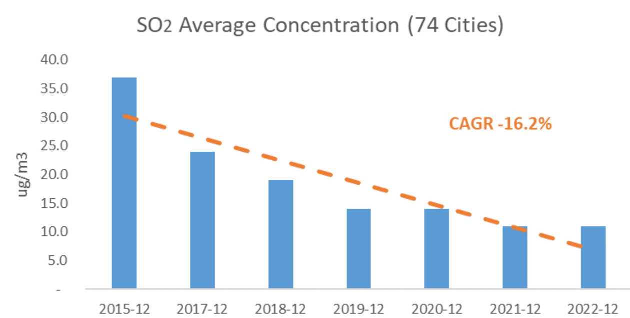
Bin Yuan Environment Tracking

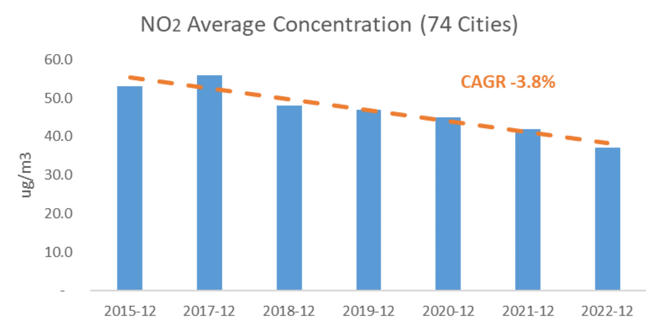
This tracking includes monthly air and water quality data, both showed steady improving trend in the last 5 years. Air pollution concentration dropped due to reduced coal combustion, increased proportion of new energy vehicles, and tightened emission control measures. Water quality improved mainly from the strengthen control of wastewater emissions since 2017.

China air pollutant concentration data December 2015-2023



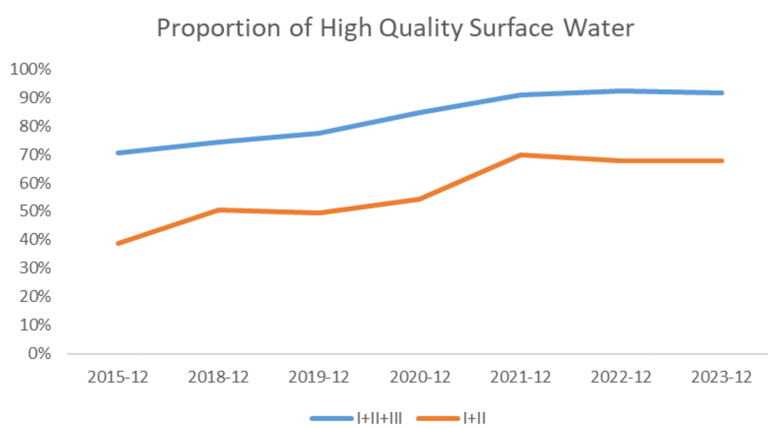






**PM2.5, PM10 and SO_2 are mainly from fossil fuel combustion, and NO_2 is mainly from vehicle emissions.*

The proportion of high-quality water in China data December 2015-2023



**Water quality in China breaks down to 5 levels, with level I being the best and level V being the worst. Level I+II represents water that can be used for drinking purpose. Level I+II+III represents water that can directly contact human body.*

**Source: Ministry of Ecological Environment in China.*

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