Bin Yuan Capital All China Strategy – June 2024

Performance Attribution and Bin Yuan Comment

After positive returns in the first two months of Q2, the China market had a negative return of -2.47% in June. The decline was contributed to a lack of major positive economic news with the June PMI dipped slightly lower (although remaining above expansion levels) and the central bank maintained its Loan Prime Rate (LPR) without implementing more aggressive pro-growth policies. Geopolitical uncertainties worldwide have not helped sentiment. The market saw capital outflows for the month after inflows started in late April.

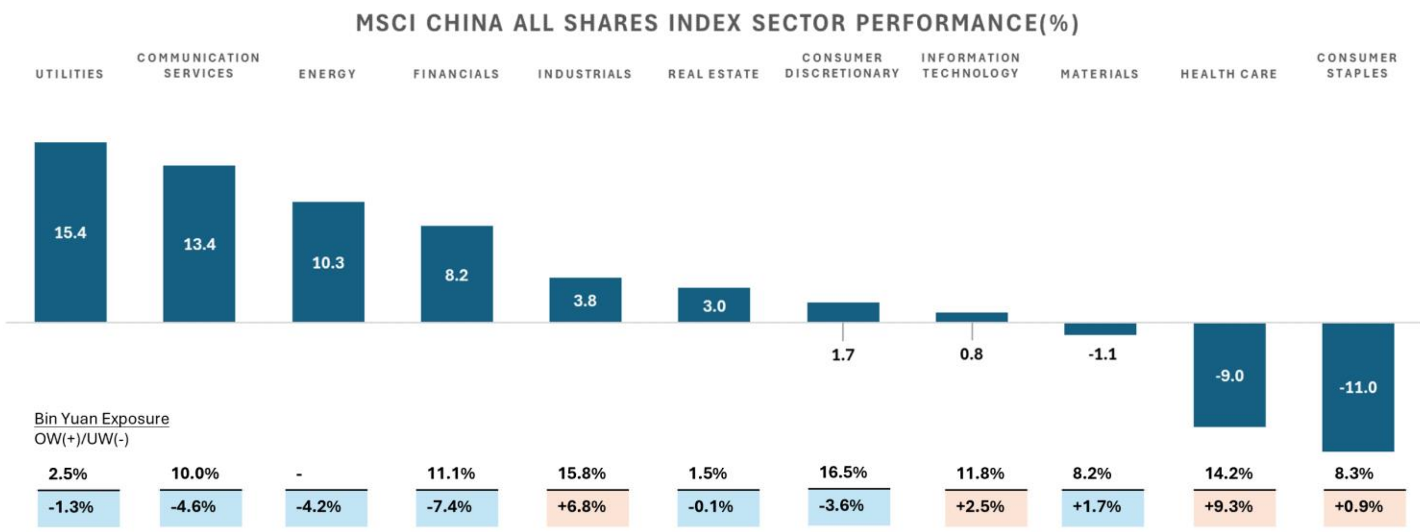
During the month, our portfolio decreased by 2.96%, underperforming the benchmark by 49 basis points, driven by our overweight position in healthcare sector. Within our portfolio, Nari showed the strongest performance, while Shanxi Fenjiu lagged behind.

NARI outperformed in June as the rapid development of renewable power generated strong demand for "Smart Power Grid" and Ultra-High-Voltage Direct Current (UHVDC) Transmission. As a software and equipment supplier with a dominant position in China's power industry, NARI should be the leader in the construction of China's "Smart Power Grid". The National Energy Administration announced released a document about accelerating the construction of UHVDC Transmission (3~4 DC lines were built in past 3 years, but about 10 DC lines are expected to be completed in the next 3 years), which means NARI should have a stronger potential for growth in the next couple of years. Also, NARI's smart grid system benefits from increasing the renewable energy proportion in total energy consumption.

Shanxi Fenjiu underperformed in June, mainly due to the decline in Moutai's end-market retail prices in June, which led to market concerns about the overall demand for Baijiu, driving down the Baijiu sector. However, Moutai represents the high-end baijiu market, while Fenjiu is in the mid to sub-high-end market, where retail prices remained stable. We remain positive on the sub high-end (500-700 yuan per bottle) Baijiu market, which is expected to grow at a CAGR of 15% over the next 5 years. Fenjiu shows strong growth potential both in terms of selling volume and average selling price because it has a low-price base and its popularity among consumers is increasing. Currently the consumption market is weak, and the brands with strong brand images should become more competitive and consolidate the market. Fenjiu is undoubtedly a leader in the clear aroma space, which should benefit from market consolidation. Our crosschecks of selling channels reported that Fenjiu's turnover is very high in the channels, reflecting strong consumption demand.

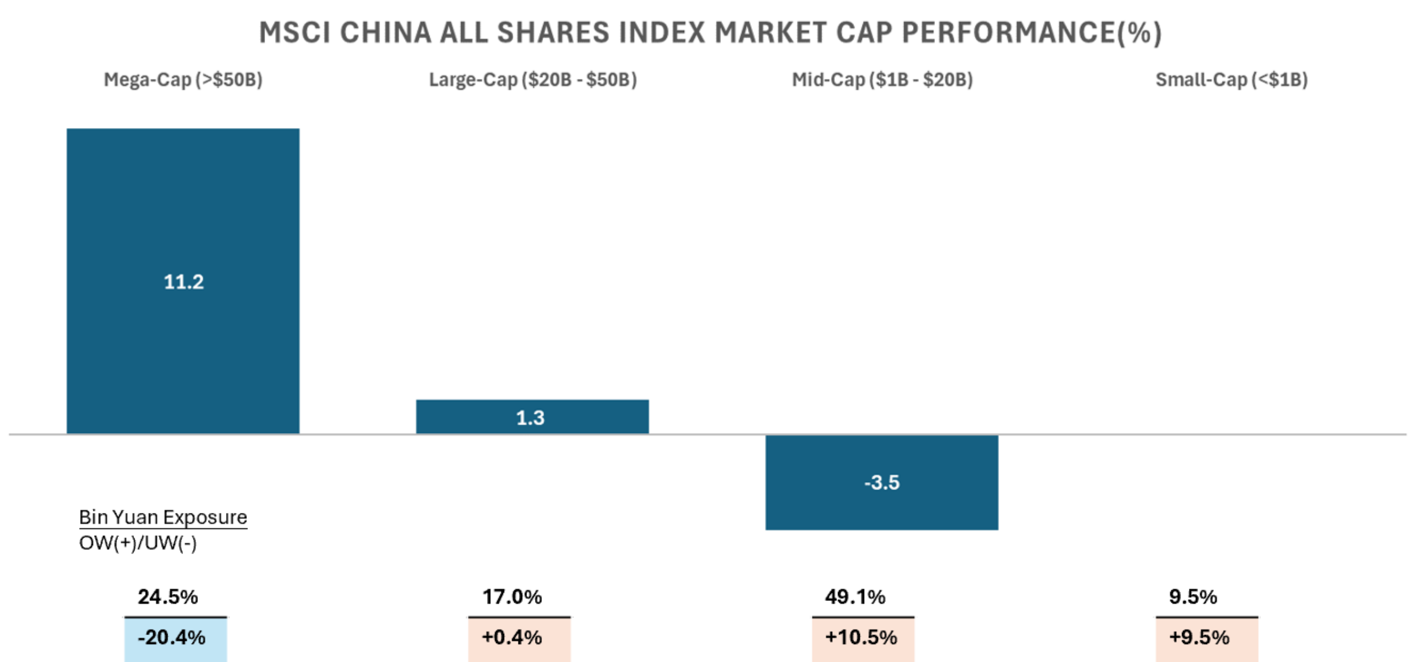
Q2 2024 saw significant divergence of performance among different market caps and sectors, driven by capital outflows or a lack of incremental capital inflows. Large caps in the Utilities, Internet, Energy, and Financials sectors outperformed, diverting liquidity away from the mid-cap Consumer, Healthcare, and Information Technology names, which fell out of favor.

Chart 1: MSCI China All Shares Index Sector Performance (%) in 2Q 2024



Source: MSCI, Bloomberg, Bin Yuan Capital

Chart 2: MSCI China All Shares Index Market Cap Performance (%) in 2Q 2024



Source: MSCI, Bloomberg, Bin Yuan Capital

Although the market remains weak with high volatility and no clear trend, most concerns and negative factors have already been priced in, and the market appears to be building a bottom base. We advise our investors to watch for the following positive signs:

1. Property Stabilization – First tier cities such as Shanghai, Guangzhou, and Shenzhen have implemented optimized real estate policies. Preliminary signs of improved transactions on a month-over-month basis have appeared in the top ten cities. Liquidity in these first-tier cities is improving and is expected to boost transactions, especially for existing homes. The stabilization of the property market is likely to mitigate its negative impact on the overall economy. (Please see our monthly comment, below, for our updated view on property market.)

2. Pro-Growth Government Reform - The Plenum meeting to be held in mid-July will focus on long-term structural reform measures to address growth bottlenecks. Topics may include: 1) Technological innovation and industrial upgrading supported by the national system to ensure the security and self-sufficiency of the industrial chain; 2) Reform of the fiscal, land, and tax systems to efficiently allocate resources; 3) Guarantees for low-income groups; 4) Supply-side reforms to address overcapacity issues.

3. Favorable Macro Data and Earnings Base Effect in 2H - We expect incremental growth to accelerate in the healthcare, semiconductor, consumer electronics, and consumption sectors, as well as property-related sectors (particularly existing homes), aided by a favorable base effect.

We are confident in the fundamental strength of our portfolio amidst a backdrop of moderate economic recovery. Leading companies in their respective industries are poised to deliver high visible growth. Amidst geopolitical uncertainties and liquidity outflows, our investors have a compelling opportunity to acquire high quality holdings at highly attractive valuations. While we cannot be certain of the timing of performance recovery, we believe we are steadily approaching that point.

A Reappraisal of China's Property Market

The turmoil in China's property market over the past few years has raised deep concerns among both domestic and global investors. After three years of declines, new home sales continue to drop on a month on month and year on year basis. Investors' concerns are focused not only on the property sector itself, but also on the property sector's impact on the macro economy, especially after the liquidity crisis following the strict regulations imposed since 2020 and the bankruptcy of many developers.

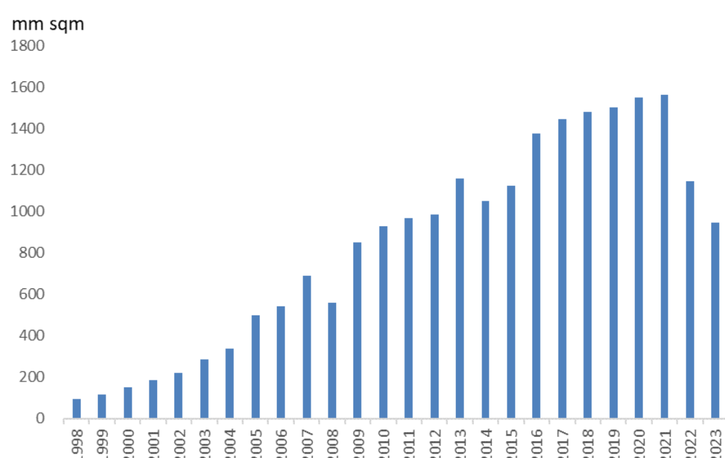
Bin Yuan has had a cautious view on the country's property market since 2018. But at the current moment we believe investors can be less negative. New home sales remain weak, but it has become less of a drag on the economy. Existing home transactions are rising to become an increasingly important proportion of the market. This structural change brings opportunities in some overlooked property related sectors and companies.

The Prosperity of New Homes Has Past

Since the privatization of housing in the 1990s, China's property market saw three decades of prosperity. Annual new home sales grew nearly tenfold from 162 million sqm to 1,549 million sqm, a CAGR of 11% on rising housing demand from rapid urbanization and the rise of disposable income from 1999-2021.

In its late stages, this rapid development showed signs of irrational exuberance with excessive land purchases by over-leveraged developers and speculation by home buyers.

Chart 1. New Home Sales in 1998-2023



Source: National Bureau of Statistics of China (NBS), Bin Yuan Capital, iFund

The government started making efforts to deflate the property bubble in 2016, with cooling down measures like home purchasing curbs and new home price caps, among others. But the supply side, due to the long-cycle from land purchase to housing completion, did not respond to slowing demand until 2021.

After three years of declines, annual new home sales have fallen back to the level of 2010 and will continue to be weak in the medium term before gradually stabilizing. The decline in new home sales is the result of a return to rational market behavior following a series of deleveraging efforts by the government.

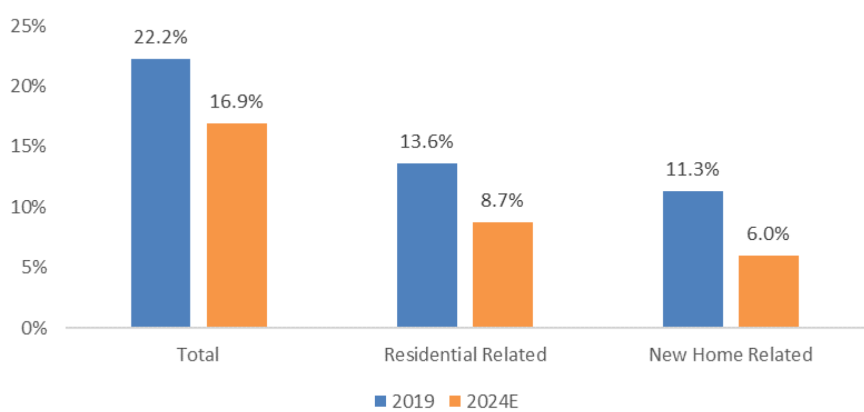
Less of a Drag on the Economy

China's economy is usually viewed as heavily dependent on the property market, with a 22% contribution to GDP in 2019 from related sectors such as real estate development, building materials, construction, construction machinery, furniture, home appliances.

However, these sectors also generate revenues from non-residential activities such as infrastructure and commercial building construction. Excluding the contribution from non-residential activities, **the residential contribution to GDP would be only 9% in 2024E versus 14% in 2019.**

An in-depth analysis of the residential housing number shows that the contribution of new home sales to GDP is actually only 6% in 2024E versus 11% in 2019 and the contribution is expected to decline further as the share of new home sales as a percentage of property sales fall over the medium term.

Chart 2. Property-Related Sectors' Contribution to GDP



Source: NBS, Various Public Reports, Bin Yuan Capital

Trillion RMB	Real Estate	Furniture	Home Appliance	Building Material	Engineering Machinery	Construction	Sub-total	GDP
GDP by segment 2019	7.0	0.7	1.6	4.8	0.7	7.1	21.9	98.7
GDP by segment 2024E	6.3	0.6	1.7	4.0	0.8	9.1	22.4	132.4
CAGR 2019-2024	-2.3%	-3.7%	1.6%	-3.7%	0.8%	5.2%	0.4%	6.1%
% of GDP 2019	7.1%	0.7%	1.6%	4.9%	0.7%	7.2%	22.2%	
% of GDP 2024E	4.7%	0.4%	1.3%	3.0%	0.6%	6.9%	16.9%	
Residential Related 2019	70%	90%	75%	75%	35%	40%		
Residential Related 2024E	70%	90%	70%	65%	15%	30%		
Residential Related % of GDP 2019	5.0%	0.6%	1.2%	3.6%	0.3%	2.9%	13.6%	
Residential Related % of GDP 2024E	3.3%	0.4%	0.9%	2.0%	0.1%	2.1%	8.7%	
New Home Related 2019	80%	95%	20%	95%	95%	95%		
New Home Related 2024E	55%	85%	15%	85%	95%	95%		
New Home Related % of GDP 2019	4.0%	0.6%	0.2%	3.5%	0.2%	2.7%	11.3%	
New Home Related % of GDP 2024E	1.8%	0.3%	0.1%	1.7%	0.1%	2.0%	6.0%	

Source: NBS, Various Public Reports, Bin Yuan Capital

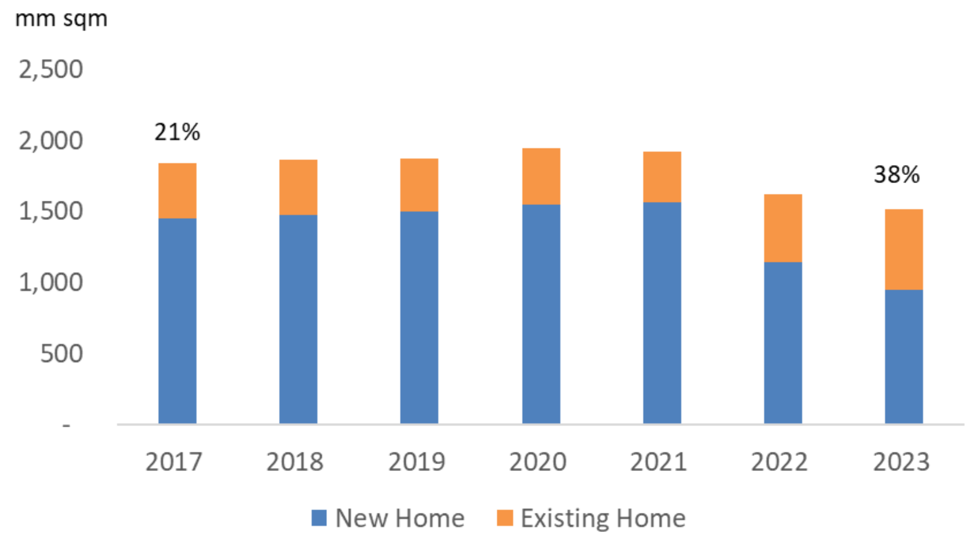
Companies in related sectors are proactively making efforts to reduce the negative impact from declining new home sales to find growth elsewhere:

- Construction machinery leaders like Sany saw overseas revenue rose from 19% in 2019 to 58% in 2023 and Hengli Hydraulic (18% to 21%) showed the similar trend. They also seek opportunities in infrastructure, rural development and industrial areas domestically.
- Top home appliance manufacturers like Haier (47% to 52%) are expanding their presence in overseas markets, and their domestic sales are mostly driven by replacement rather than new home sales.
- Building materials companies, like waterproofing material maker Oriental Yuhong, in addition to expanding into overseas markets, are increasingly focusing on the retail market to tap potential in the existing home market related services like refurnishing and repairs.
- Construction companies, like China State Construction Engineering Corp., are also targeting orders from non-residential projects, and residential orders have fallen to 24% in 2023 from 40% in 2021.

Long Term Housing Transaction Volume Remains Solid

The sales of existing homes have significantly outperformed the sales of new homes. Annual existing home transactions grew over 50% between 2017 and 2023, from less than 400 million sqm to 600 million sqm, a CAGR of 6%. Existing home transactions accounted for 38% of total home transactions as of 2023, up from 21% six years ago.

Chart 3. Home Transaction Structure 2017-2023



Source: NBS, Various Public Reports, Bin Yuan Capital

We believe, unlike some pessimistic analysts, that consumer demand for housing will not disappear but instead find new outlets such as demand for existing homes. Our analysis of total housing demand on a long-term basis leads us to conclude that **the following trends will continue to support consumer demand for housing:**

✓ **Ongoing urbanization and increase in per capita housing space.** China had a population of 1.4 billion in 2023, with an annual population growth rate of negative 0.1%, an urbanization rate of 66%, and a per capita housing area of 42 sqm (the U.S. 67 sqm, Germany 46 sqm, France 40 sqm as of 2021). Assuming a negative 0.3% population growth, a 0.5 percent rise in the urbanization rate each year, a 0.14 sqm annual increase in per capita housing area (46 sqm as of 2050, the same level with Germany in 2021), about **8 billion sqm (300 mm sqm each year)** of demand for new urban housing would be generated during the period 2024-2050.

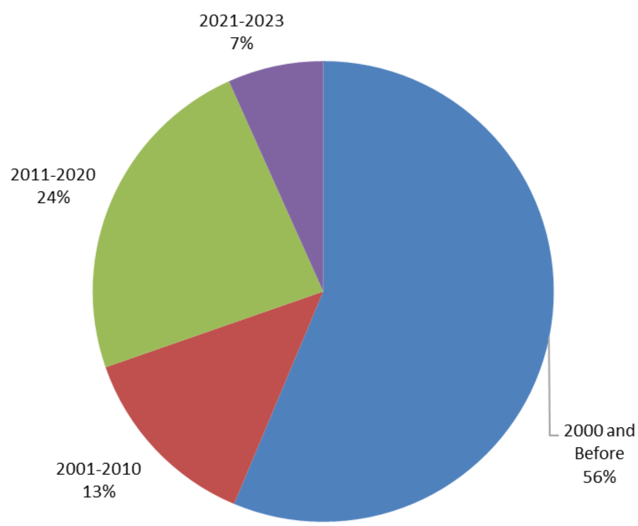
	Total Population -million	Urbanization Rate %	Urban Population -million	Accumulated Urban Housing Area 2023 Total Urban Housing Demand 2050E -billion sqm	Per Capita Housing Area -sqm
2023	1,410	66%	933	39.6	42.4
2050E	1,285	80%	1,023	47.4	46.3
Change in 2023-2050E	-125	14%	91	7.8	3.9
Annual Change	-5	0.5%	3	0.3	0.14

Source: NBS, Bin Yuan Capital

✓ **Housing improvement/upgrades.** Assuming there will be at least a one time home upgrade/improvement after 10-20 years for home buyers due to life changes such as marriage, parenthood, etc., then, there would be demand for **over 23 billion sqm (800 mm sqm each year)** in 2024-2050.

✓ **Old home depletion.** Existing homes in urban areas exceeded 39 billion sqm as of 2023, with 56% of these homes built before 2001. According to a public survey, about 6.9 billion sqm of old houses were built before 1990. Assuming an average lifespan of 50-70 years, if the old houses are gradually rebuilt over the next 30 years, then there would be **demand for 260 mm sqm per year**.

Chart 4. Existing Home Structure by Time Built



Source: NBS, Various Public Reports, Bin Yuan Capital

We estimate that **there will be housing demand for about 1.4 billion sqm annually over the next two decades.** Total transactions of new homes and existing homes in 2023 was 1.5 billion sqm, very close to the low-end demand estimates in our forecast.

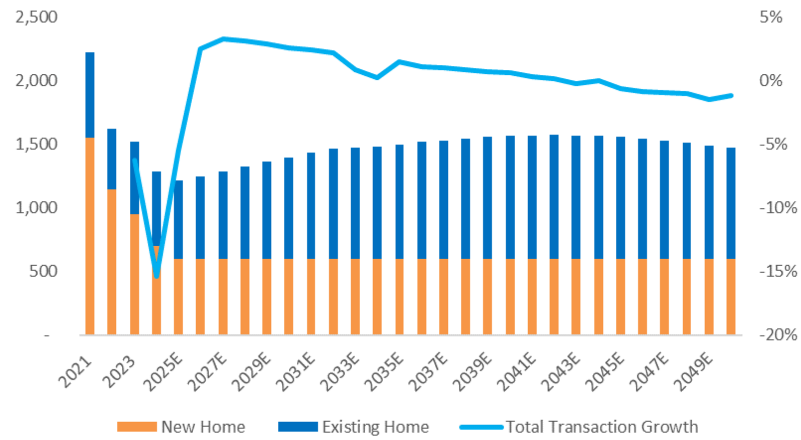
Millions	Annual Housing Demand Forecast
Urbanization and Per Capital Housing Area Increase	300
Upgrade/Improvement	800
Old House Depletion	260
Total	1,360

Source: NBS, Various Public Reports, Bin Yuan Capital

Over the next 25 years, we expect total housing transactions to gradually stabilize and shift to an “upgrade-driven stage” from the previous “new construction-driven” stage.

New home sales would remain weak in the medium term, and then gradually stabilize. Existing home sales would continue to outperform new home sales and rise to represent 60% of total transactions from the current level of 38%.

Chart 5. Total Transaction Structure and Growth

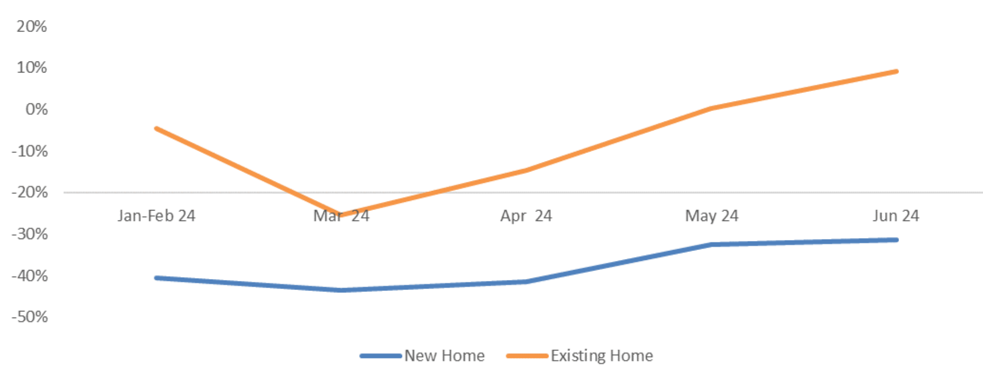


Source: NBS, Various Public Reports, Bin Yuan Capital

Investment Opportunities

Confidence in the property market has been improving as a result of ongoing policy stimulus. After more than three years of price drops, home buyers are gradually coming back to the market. According to the latest data, monthly existing home transactions in Beijing and Shanghai in June have recovered above the trend level. The total existing home transactions market has also see improvement since February. This is in line with our observations during our frequent onsite visits to housing brokers in Shanghai, talks with our own friends and relatives, and real estate agents and residents in other cities during company visits.

Chart 6. New Home Sales (54 Sample Cities) and Existing Home Transaction (26 Sample Cities) YoY Growth Jan-June 2024



Source: Hua Tai Securities, Beike, Bin Yuan Capital

The property market itself, like other property-related sectors, is also seeing less influence from new home sales. We observe a shift to existing home transactions, and opportunities might emerge from existing home services like brokerage platform, (re)furnishing, repairs, rentals, etc. if investors are too bearish on the whole property sector.

Suofeiya

Suofeiya (SFY) is the second largest customized cabinetry maker in China. The company has established a branded portfolio targeting different groups of customers within various price ranges, and built a comprehensive sales network that covers distributors, furnishing companies, and SoE property developers. Products offered include wardrobes/closets, doors, windows, etc.

Source: Suofeiya's website

The company has established an efficient supply chain (orders delivered in 7-12 days) and extensive sales network (2,500 distributors with 4,000 stores).

It is expected to benefit from rising cross sales based on its comprehensive brand and product portfolio, increasing contributions from the home furnishing channel (16% of revenue, +65% yoy in 2023), especially as housing transactions gradually stabilize in the future. Suofeiya's market share should continue to grow amid industry consolidation after recent weakness in the downstream property market.

The company has eight digitalized factories equipped with advanced IT systems around the country, which helps it respond to customized demand quickly with flexible production plans. Order deliveries have been shortened to about 7-12 days, with a low rate of return for repair.

We believe there is still solid housing demand in the long-term. Structural change is happening, with rising transactions of existing homes and decreasing new home sales. As new home sales become less of a drag and existing home transactions gradually stabilize, we are cautiously optimistic on the undervalued companies like Suofeiya (dividend yield of 6+%), who should see growth momentum and continue to take market share in a new upgrade driven cycle.

Sincerely,

Ping and the Team

July 5, 2024

Bin Yuan on the Road

Jun 2, 2024

We visited Piotech's (a semiconductor manufacturer) factory in Shenyang in June, learned the production process of thin film deposition semiconductor equipment as well as the status of developments in the industry.

We visited to check if the industry's prosperity continues as expected and found out that the factory is operating at full capacity. We communicated with the management team, and they ar**e optimistic about industry growth over the next few years, and they are confident to have breakthroughs in high-end equipment and to take more market share in the thin film deposition area.**

"We will try our best to make achievements in advanced process technology in thin film deposition." – Board Secretary Zhao Xi

Jun 15, 2024

In June, we visited Supcon Technology to learned about the company's development history and its current "1+2+N" development strategy. As a leader in domestic industrial control systems, the company has top market share in DCS, SIS, APC, MES, and other fields for many years. It is expected to be the first to benefit from the development of the domestic process industry and the improvement of the domestic industrial control system's localization rate.

During the visit, we found that the company is gradually transitioning from a single control system supplier to providing overall intelligent factory solutions. The company's newly developed UCS system saves 80% of the cables and cabinets compared to the traditional DCS, which can significantly reduce corporate costs. The company has also developed the TPT model, paving the way for the company's industrial software to move towards a subscription model. The development of these new products can help the company achieve new growth targets.

"In the future, Supcon will innovate continuously to help customers succeed." – Board Director, Cui Shan

Jun 24, 2024

We visited a leading domestic smart meter company that has excellent products in both the electricity usage side and the power distribution networks and has actively participated in the construction of power grids both domestically and internationally.

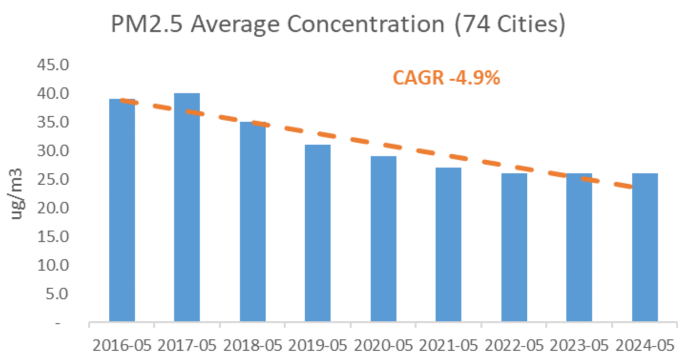
The visit was aimed at understanding the construction of smart grids from the perspective of electricity consumption and distribution, and to understand the overall construction efforts and the demand of smart power grid. We learned that the demand for smart meters is growing at an annual rate of more than 10% both domestically and internationally, and the demand for distribution network products has also accelerated in recent years. Based on this information, we get indirect confirmation that the demand for smart power grids is trending upwards.

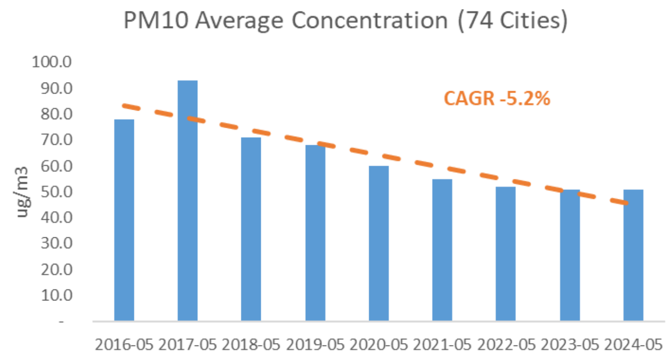
"The company will assist in the construction of global smart grids." – Board Secretary

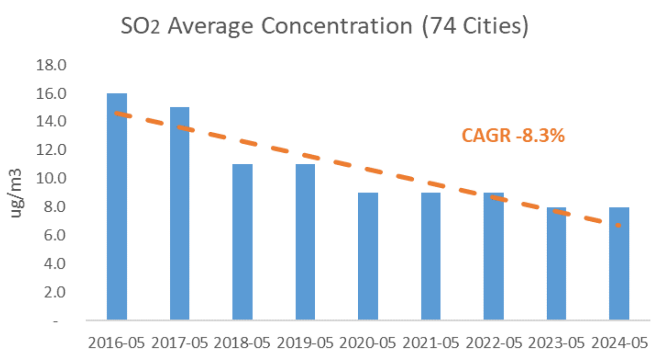
Bin Yuan Environment Tracking

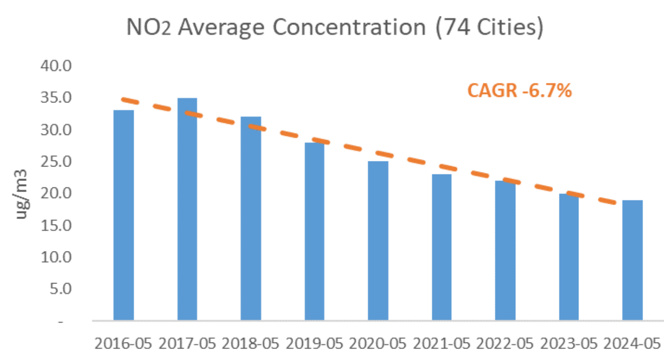
This tracking includes monthly air and water quality data, both showed steady improving trend in the last 5 years. Air pollution concentration dropped due to reduced coal combustion, increased proportion of new energy vehicles, and tightened emission control measures. Water quality improved mainly from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

China air pollutant concentration data May 2016-2024



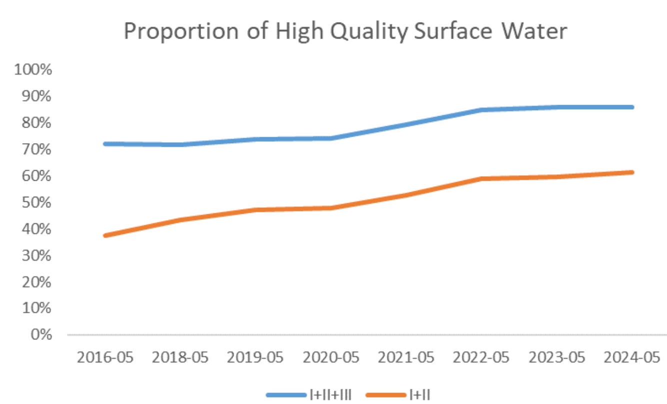






**PM2.5, PM10 and SO_2 are mainly from fossil fuel combustion, and NO_2 is mainly from vehicle emissions.*

The proportion of high-quality water in China data May 2016-2024



**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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