China’s outbound tourism boom reaches an inflection point.

This year, 120 million Chinese tourists are expected to travel outside of mainland China, as China’s outbound tourism boom reaches an inflection point. With tourism taking off and the combined effect of supply side reform with the progressing RMB internationalisation, China’s economy is changing shape.

Our investment strategy has proven to gain stronger re-rating potential under a stabilised market. We believe our strategy – investing in undervalued growth stocks – will continue to yield higher returns for the remainder of 2016 and into 2017, as the market takes off. In addition, we expect investors will focus more on market valuation and shift their allocation to the cheaper H-Share market; where the majority of our holdings reside.

We have identified four major investment themes and have positioned the New Capital China Equity Fund accordingly. These themes are more resilient to external economic influences and mean the Fund should be well positioned to capture additional upside from these niche areas of the market:

1. CHINA TOURISM BOOM
2. SHENZEN HK CONNECT
3. AH PREMIUM
4. STATE-OWNED ENTERPRISE (SOE) REFORM

Source: EFGAM as at 15 Sep 2016. Percentage split of portfolio allocated to each investment theme.
1. CHINA TOURISM BOOM

While the air traffic penetration rate in China is still low, we expect China’s tourism market will grow at a fast pace backed by the rising GDP per capita. The tourism sector is set to benefit from favourable government policy e.g. relaxation of visa policy and public holiday reform.

International departures (million)

- Premier Li Keqiang emphasised the tourism industry as the key strategy for China’s growth engine to stimulate economic growth and create jobs.
- We have built up positions in various sectors which benefit from this fast growing trend, including:
  - Airline operators
  - Aircraft leasing companies
  - Duty free operators
  - A monopolized ticket distribution system provider

Stock Example: TravelSky Technology (696 HK Equity)

Rosy Outlook For Air Ticketing Service in China

- TravelSky (TSK) provides IT solutions for China’s air travel and is a major global distribution system provider in China with a near monopoly and high barriers to entry.
  - TSK will benefit from China’s strong air traffic growth and increasing airport expansion in the next three to five years.
  - The company enjoys strong shareholder support, i.e. its major airline customers are also owners.
  - We like TSK’s asset light model, stable cash flow and strong ROE.
  - The stock is also being added into the Hang Seng Composite Small Cap Index, and is available to southbound investors.
2. SHENZHEN HK CONNECT = RMB INTERNATIONALISATION

Niche mid-cap companies in HK should benefit from the upcoming southbound flow from Chinese investors.

- **Shenzhen Northbound Connect**
  - ~880 stocks for SZ Northbound covering:
    - Constituents of SZSE Component & SZSE Small/Mid Cap Innovation indexes with a market capitalization of at least RMB 6 bn, and SZSE-SEHK A+H shares
    - Main board: ~270, SME board ~410, ChiNext board ~200
  - ChiNext open to institutional professional investors initially
  - Daily Quota: RMB 13 bn

- **Shenzhen Southbound Connect**
  - ~417 stocks (vs. 318 stocks for SH Southbound) for SZ Southbound, adding:
    - Constituents of Hang Seng SmallCap Index with a market capitalization of at least HKD 5 bn and SZSE-SEHK A+H shares to the existing eligible stocks
  - Daily Quota: RMB 10.5 bn

- **Shanghai + Shenzhen**
  - Aggregate Quota abolished
  - ETFs to be included but roll-out planned in 2017
  - SH Connect otherwise remains unchanged

Source: Hong Kong Exchange. Estimated data as of end July 2016.

3. AH PREMIUM

The launch of the Shenzhen HK Connect program should see premium compression of AH Shares. We pick the undervalued and quality H-Share companies which are trading at deep discount to their NAVs.

**Stock Example: China Eastern Airlines H-Share (670 HK Equity)**

A Beneficiary of China Outbound Tourism and an A/H Discount Play

- China Eastern Airlines is one of the three largest Chinese airlines. The company operates passenger and cargo airline services and uses Shanghai Pudong Airport as its base. The US Delta Airline is its strategic partner.
  - The company will benefit from the outbound tourism in China, expanding its fleet and its routes with a healthy passenger load factor still above 80%. It also benefits from lower oil prices as it does not hedge fuel cost.
  - Ctrip has become a shareholder of its A-Share with a 3.22% stake and plans to increase its stake to 10% in the market in the next 12 months.
  - China Eastern’s H-Share is trading at 1.2X P/B and 5.6X P/E. It’s H-Share is at 50% discount to A-Share.

Source: Bloomberg; from Jun 2013 to Jun 2016.
4. STATE-OWNED ENTERPRISE (SOE) REFORM

SOE companies which will benefit from corporate / industry reform plans. These restructuring activities include: management share option schemes, M&A and disposing of non-core assets.

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<th>Company Restructuring</th>
<th>Asset Injection</th>
<th>Stock Incentive Plan</th>
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SOE Reform Investment

Source: EFG Asset Management.

Stock Example: China Everbright Ltd (165 HK Equity)

A Unique China Fund Manager and an SOE Reform Candidate

- China Everbright Ltd was established in HK in 1997 as the listed subsidiary of China Everbright Group. The Company is also the second largest shareholder of Everbright Securities and a strategic shareholder of China Everbright Bank.
  - Following the whole group restructuring, China Everbright Ltd will focus on cross-border asset management and investment business. Its holdings at Everbright Securities and China Everbright Bank are classified as non-core assets and will be disposed.
  - China Everbright Ltd will adopt an asset light business model and become a true asset management company.
  - The company is trading at a 20% discount to its book value.

We still expect the Chinese equity market to experience volatility, mainly brought by external risks. A potential US rate hike in 2H16 would be a key source of volatility, which will further strengthen the US dollar and create the concern of portfolio outflow in Asia. However, we feel confident that the New Capital China Equity Fund is well positioned, via its investment themes, in areas of the economy which are less affected by broader external market influences and can take advantage of the continued upside we believe is on the horizon.