MOI GLOBAL

# Quarterly Update and Commentary of FM First China Fund, LLC

*This article is adapted from a letter by Sean Huang, Managing Partner and Portfolio Manager at First Beijing Investment Limited, and Adam Schwartz, Senior Managing Director and Portfolio Manager at First Manhattan Co., based in New York City.*

In our 1Q letter, we outlined FM First China Fund LLC's (the "Fund") investments in leading companies in four key sectors, which accounted for approximately 80% of the Fund's capital, and why we believe they were well positioned to weather the impacts of the pandemic. We are pleased to report that most of the Fund's portfolio companies appear to be emerging from the pandemic seemingly stronger than before, with increased market share and enhanced competitive advantages over their peers.

Following the format of our 1Q letter, we share recent operational updates across these four sectors:

**After-School Tutoring**

The Fund owns various leading companies in the afterschool tutoring industry.

The Fund's portfolio education companies announced over 20% YoY revenue growth for the first calendar quarter of 2020. Management expects growth to accelerate in the coming years because a substantial number of smaller tutoring companies are exiting the business. These smaller players failed to convert classes to online. The migration of tutors and students from smaller tutoring companies to larger ones continues and appears likely to benefit the leading industry players.

Another unintended benefit brought about by COVID-19 has been the adoption of online tutoring functions. As offline classes slowly come back, we expect leading companies will use online functions to enhance interactions with students and their parents. The result could be improved stickiness and the ability to offer complementary courses online, in addition to the offline courses.

**Infant Formula**

During the first half of 2020, the two leading infant-formula companies in the Fund's portfolio grew sales and profits by more than 25% yearover-year (YoY). Management teams of the leading local companies have adapted by increasing the number of in-person activities with new and expectant mothers. They are gaining market share from both multinational companies and local players with less control over their distribution channels and increased bureaucracy. Both of companies are projecting meaningful growth for 2020.

**Internet**

Bilibili (NASDAQ:BILI) was one of the best performing Chinese internet stocks during the first half of 2020. We have owned Bilibili since its IPO in 2018. 1Q 2020 revenues and users grew by 69% and 70% YoY, respectively. The strength of Bilibili's business model is that the value of the platform and the richness of its content grow exponentially as the number of users increases.

The Fund also took the opportunity to acquire a significant position in a leading medical aesthetics company during 2Q 2020. Although COVID19 has made it difficult for people to get surgeries or seek offline consultations, temporarily reducing the company's revenues for 1Q 2020, the company's management has made significant progress in rolling out new features on the core app. These efforts are widening the company's moat as the leading medical aesthetics online community app in China. This category has not yet developed in the west and therefore may be hard to fully appreciate.

According to our analysis, this company has the potential to grow profits significantly for the next three years, and it currently trades at only 13 times our forecast for 2021 earnings.

**Real Estate**

After a temporary pullback during February and March, real estate sales across China have resumed growth as of April 2020. On average, our portfolio of real estate companies has grown sales during the first half of 2020 by about 19% and continues to consolidate markets.

Despite the growth in sales of their businesses, stock prices of real estate companies have performed poorly during the first half of 2020 and continue to trade at extremely attractive valuations. Our portfolio of real estate companies trades at a weighted average price-to-earnings ratio of 4.4x, a weighted average cash dividend yield of 6.6%, and is estimated to grow profits by approximately 20% for 2020.

The portfolio's real estate investments, accounting for 30% of the Fund, underperformed the portfolio substantially, as these stocks had a weighted average return of 1.7% YTD. This underperformance appears to us to be inconsistent with underlying business fundamentals. We assume that real estate's core growth characteristics remain intact based on an increase in urbanization and a rising middle class. We therefore expect the stocks of the real estate companies to be revalued to more appropriate levels over the long term.

**Summary**

Daily financial headlines highlight rising tensions between the Chinese and U.S. governments. Despite the rhetoric, senior officials from both countries appear to be committed to pushing forward with Phase One of the trade deal.

The U.S. government occasionally threatens to delist Chinese companies from U.S. exchanges. In response, many Chinese companies dual list on the Hong Kong Stock Exchange. Alibaba (NYSE:BABA and HKEX:9988) was the first, followed by JD.com (NASDAQ:JD and HKEX:9618) and NetEase (NASDAQ:NTES and HKEX:9999). Stock prices on both exchanges rose for these three companies, as all three are large household names more widely understood and appreciated by Chinese investors, who can more easily invest on the Hong Kong Stock Exchange. Additionally, the shares are fully fungible between the two exchanges, thus pushing up prices on both exchanges. We are aware of indications that ten additional companies, including Bilibili and two more portfolio companies, are now in the process of applying for dual listings.

We believe that recent demands by U.S. regulators to allow inspections by the Public Company Accounting Oversight Board (PCAOB) are reasonable and that the Chinese government will eventually comply. Experts that we have consulted believe that the Chinese government is likely to agree to some form of the inspections which will keep the Chinese companies listed on the U.S. exchanges. However, we are not sure to what degree this will decrease the likelihood of frauds. Most Chinese companies listed in the U.S. – such as Luckin Coffee (OTC:LKNCY) – are already audited by the Big Four accounting firms, whose audits are at least as comprehensive and stringent as those selectively imposed by the PCAOB. As Chinese regulatory and business environments mature, the burden of performing due diligence on individual companies rests squarely with the investors, not the regulators. In China, this due diligence remains a labor-intensive process that requires deep local expertise.

On the whole, U.S.-listed Chinese companies have created tremendous shareholder value for U.S investors. In return, the increased quality of best business practices and corporate governance required by U.S. regulators, institutions, and investors have helped Chinese companies become more competitive and responsible global players. (To be clear, there is still plenty of work to do here.) This trend benefits consumers and investors in China, as well as shareholders around the world. The ability for U.S. investors to take part in the growth of Chinese companies has been a win-win situation for both countries and is important to peaceful coexistence between the two countries. We are pleased to be contributing our small part by connecting western investors to high-quality publicly traded Chinese companies and their management teams.

We are most proud of the focus and poise shown by the First Beijing research team during the pandemic. The level of in-depth research and analysis that our team has continued to generate gave us the confidence to stay calm and the conviction to add to our holdings during a period of high volatility and uncertainty. We are as confident as ever that the team is well positioned to capture greater value for our investors going forward.