HEIJIN CAPITAL

HEIJIN CAPITAL BI-WEEKLY INVESTMENT COMMENTARY

May 19th – June 2nd, 2019

Global Portfolio Holdings Weekly

Executive Summary

→ WTI Crude Oil

WTI Crude Oil has taken a big hit this week. It has plummeted over 15% in just two short weeks due to the fears with the trade war as well as with bearish U.S. rig counts. But, it seems like a lot of traders have their mind wandering in the trade war wears on the most part and are forgetting to look at OPEC output that is falling rapidly and with the contamination problem in Russia that is far worse than expected. In other words, with the current supply and demand figures in today's market, the oil market is actually much tighter than it appears. Thus, Heijin would not be surprised to see a recovery in WTI and Brent Crude prices in June-July-August. After all, OPEC production stands at the lowest level in the past 4 years.

→ Update on Tariff Man - President Trump

Apparently, it is not enough to try to fight China in a trade war and so Trump has decided to open his tariff threats again, but this time aimed at Mexico. Trump stated he is willing to implement a 5% tariff on all goods imported from Mexico, which could be set by next Sunday. This set avocado prices to skyrocket, which must have disappointed millennials across the globe. This would also cost the U.S. $2m more every day as they actually import just under 700,000bpd from Mexico. The Heijin team will look at what further implications this 5% import tariff could have on Mexico and on the U.S. as well as what market inefficiencies can be taken advantage of.

INDEX	CLOSE	2 WEEKS	YTD
Dow Jones Industrial Average	24,903	-1.99%	7.81%
S&P 500 Index	2,763	-1.81%	11.1%
NASDAQ	7,477	-1.75%	13.53%
10-yr Treasury Yield	2.13%	-0.26%	-0.55%
Oil ($/bbl)	$53.37	-15.1%	17.5%
Bonds	$110.4	1.2%	4.7%

*bonds are represented by the iShares Core U.S. Aggregate Bond ETF

Market Summary & Strategy

Global Macro

What Soaring Chinese Pork Prices Tell Us

The price of pork is expected to remain high in China, the world's largest consumer of the meat, as stocks may take months – and even years – to return to standard amid one of the worst outbreaks of African swine fever in history. This viral disease, which doesn't affect humans, wiped out an estimated 20% of China's population of pigs. Moreover, it has become endemic in the regions of Tibet and Xinjiang, which is home to some of the biggest hog farms in the country. This makes it difficult to eradicate, despite a continued effort from the Chinese government and the United Nations. The first government-confirmed cases appeared late last year. Authorities responded by culling more than 6,000 pigs and offering farmers extra compensation after the disease has ravaged the country's once 400m-strong pig population. Confirmed reports of African swine fever (ASF) tell us that the disease has spread further south in China and on into south-east Asia. Questions have emerged whether Beijing's response unwittingly helped to compound the problem and actually flooded domestic markets with potentially contaminated meat.

What's interesting is that there are plenty of farms in China with an unacknowledged outbreak; analysts from Gavekal Dragonomics in Beijing say farmers in China have taken to sending entire herds to the slaughterhouse at the first sign of ASF, rather than report to the government and receive extremely little compensation. Of course, the resulting oversupply helps explain why, after almost a year of government-ordered culling, domestic pork prices have not jumped due to shortages, whereas global markets have reacted sharply. Spot wholesale prices for Chinese pork have risen only about 8% since August, while Chicago hog futures are up more than 35%.

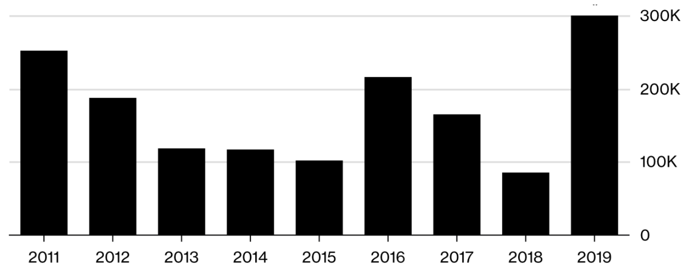
So, who is set to benefit from this shortage of pork in the Chinese market?

Well, one player is WH Group, the world's largest producer of pork and owner of Smithfield Foods of Virginia. Even though their first-quarter operating profit had taken a 10% drop due to oversupply in the US hog market, WH Group is set to profit off of this shortage by directly supplying to the Chinese market. As China killed millions of pigs to contain the virus' spread, importers need to buy supplies from abroad to make up for the loss. WH Group is said to increase exports from its US farm to China.

China's population of pigs will shrink by 134 million, or 20%, by the end of the year, the US Department of Agriculture (USDA) said last month. That puts an obligation on China to import the meat – estimated by the USDA to rise 41% this year to 2.2 million tonnes – to make up for the shortfall.
China's April pork imports jumped 24% to 135,517 tonnes from last year, according to Chinese customs data published on May 23.

WH Group and its Smithfield branch manage farms across three continents. The company butchers 33 million pigs every year in the US, 17 million in China and 5 million more in Europe. Its farms and abattoirs in the US produce 3 million tonnes of fresh pork, 25% of which is exported to 40 countries, mainly to China, Mexico, Japan, and South Korea. The company reduced its 2018 exports to China by nearly 46% to 125,000 tonnes, following a decline in pork prices and a 62% Chinese tariff as the US-China trade war gained momentum. The outbreak of the ASF is set to put a temporary truce on these tariffs as China is gearing up to increase its pork imports.

Big Bite
China plans to boost U.S. pork imports amid trade talks



* Planned purchases
General Administration of Customs

The cut in Chinese sales weighed on WH Group, causing its attributable profit to fall 21% to US$196 million in the first quarter while the operating profit declined 10% to US$341 million. This was reflected by the fall of its share price from HK$9 in early April HK$7 as of close on Friday, a decrease of about 20%. The stock also trades at a 60% discount to future cash flow value and is well in line with industry and market standards. Furthermore, the average price of pork jumped to 15.4 yuan per kilogram on May 28, compared with 13.36 yuan last August, which is not a tremendous increase considering the gravity of the situation. We believe there may be mispricing here masked by the effects of the trade war.

We will continue to monitor the situation and any updates coming from Beijing.

Industry & Investment Analysis

Microblogging in China

Sina Weibo (NASDAQ: WB) is a behemoth in the Chinese social media sector. The microblogging platform is a quasi-amalgamation of facebook and twitter. Of course, due to the restriction on the free flow of information in China, these sites that a so popular elsewhere in the world such as Facebook, Twitter, and Instagram are banned. Weibo was introduced as a new social media site that would keep the posts and news under control on the website, through blocking posts, pictures, and videos deemed 'sensitive'. Weibo is a phenomenon, their superior service coupled with their 'understanding' with authorities has allowed them to prosper, with a staggering 455 million active monthly users. This figure is even more impressive when one realised that this is well over half of all people with internet access in China, who are regularly using the site. This shows Weibo's vice-like grip on the Chinese social media market.

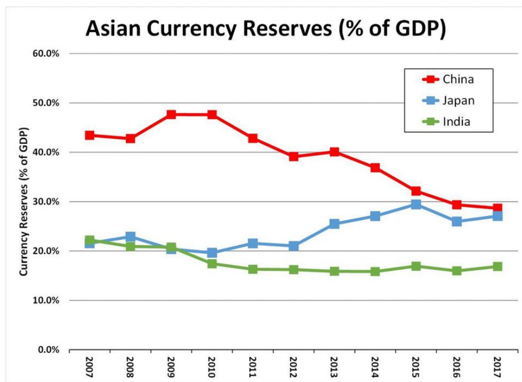
Weibo has not been without volatility; however, their stock price fell nearly 40% after Q1 earnings for 2019 were released. This dramatic drop highlights the inflated expectations of the current market, as Weibo's fundamentals were still rock solid and in fact, beat on earnings. They only fell short on revenue by $ 470,000, a frankly tiny amount for such a large company. This fall in price is absurd considering Weibo's financial health and sturdy placement in the industry. Whatsmore, for the past 3 years Weibo has been able to deliver over 20% growth year on year earnings, which begs the question as to why investors got so startled. Weibo's monthly active users are on the rise, beating Facebook's growth with activity up 13%. Heijin also has confidence in the management team who have regularly proven themselves to be adept at expanding their reach in the market, keeping on top of the demands of software and tacking any issues thus far promptly and efficiently, in particular with their cuts in spending to reduce their risk exposure in the face of the US/China trade war.

Weibo also has an enviable economic profile. With a PE ratio of 16.48, PEG ratio of 0.78, as well as a debt to equity ratio of 0.45 coupled with the fact the stock is trading only a few dollars above it, is yearly low, it's clear that it is undervalued, trading at a 34% discount of the future cash flow value of $63.22. Whatsmore the future looks strong too, Weibo has efficiently used shareholders' funds last year (Return on Equity greater than 20%) and over the past three years has regularly improved the efficiency of their capital allocation. They also used their assets more efficiently than the US Interactive Media and Services industry average last year based on Return on Assets. Moreover, in regards to their debt profile, levels of debt compared to net worth has been reduced over the past 5 years (133.2% vs 46.2% today). Debt is well covered by operating cash flow (54.3%, greater than 20% of total debt). Weibo earns more interest than it pays, coverage of interest payments is not a concern. Heijin believes that Weibo has been grossly undervalued and is an industry leader, in a sector that seems only able to expand. We will indeed be watching Weibo very closely in the coming months.

FX

The Trade War's Impact on China's Foreign Reserves

The recent tariffs the U.S. imposed on China had an immediate effect on the currency pair of both nations, with the Renminbi slumping by almost 3%; it returned to one of its lowest levels since the Great Recession. At first glance, it seems that investors and economists should not worry too much about the renminbi since China is sitting US$ 3.1 trillion foreign exchange reserves, the highest in the world. Moreover, some people argue that a weaker renminbi is beneficial to China and the global economy since it offsets some of the losses of the 25% tariffs and makes Chinese products cheaper, promoting China's exports.



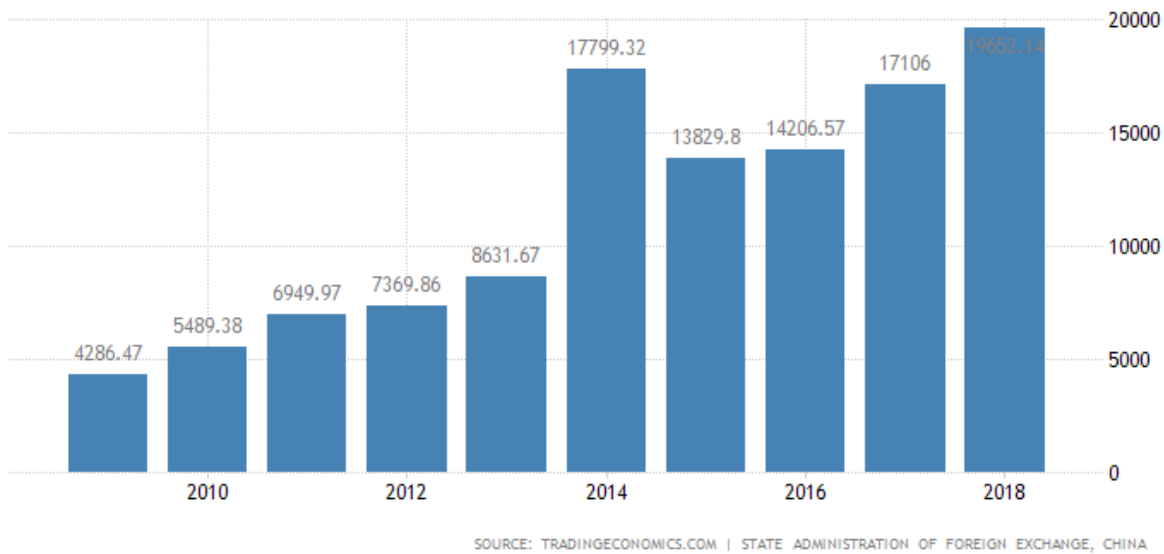
Despite having higher foreign exchange reserves in the world, they are relatively for Beijing's taste. China's foreign exchange reserves took a big hit when the stock market bubble popped in 2015. In order to stabilize the renminbi, Beijing had to burn through almost US$ 1 trillion foreign exchange reserves, a quarter of its total reserves. This being said, it is true that China has significantly increased its gold reserves in the past years; however, they are "just" worth around US$ 80 billion, which is almost insignificant in comparison to the US$ 3.1 trillion foreign exchange reserves. Moreover, although the value China's foreign exchange reserve remained relatively stable over the past decade, its GDP almost doubled diminishing the GDP to foreign reserves ratio significantly.

The combination of weakening currency and relatively low FX reserves (for China's standards) could become a ticking time bomb with China's increasing debt denominated in foreign currencies, especially in US$. Since the Great Recessions, Chinese companies have rushed to the US to borrow money, benefitting from the 3% to 5% interest rate spread between the US and China's interest rates. China's foreign debt balance rose from around US$ 0.5 trillion in 2010 to its current level of US$ 1.9 trillion. As of December 2018, short-term external debt that needs to be rolled over this year accounted for more than 60% of the total debt. Especially worrying is the growth pace of external debt since it grew by 17% in the past year and by 35% in the last two years.

Even worse, the actual external debt of China seems to be significantly higher than US$ 1.9 trillion, since the official number does not account for borrowing at financial centers such as New York, Hong Kong or Caribbean islands. According to a report by Daiwa Capital Markets, China's actual external debt lies between US$ 3 trillion and US$ 3.5 trillion.

2019 and 2020 are crucial years in China's foreign debt problem since they are peak years for repayments. Chinese corporations (or better said, the government) will have to face the decision whether to use sovereign FX reserves or buy dollars on international markets in order to repay their dollar-denominated debt. In other words, Beijing can decide between further burning through its FX reserves or to allow the renminbi to slump. Heijin Capital expects Beijing to decide for the latter, which means the renminbi could weaken significantly in the next two years.

China External Debt



China has begun to fight quite aggressively against capital outflows. For instance, in recent months some problems have been reported with US$ withdrawals. By law, every Chinese citizen is entitled to withdraw US$ 50,000 a year; however, Chinese news agencies have reported that Chinese citizens are more and more often denied withdrawals for strange reasons. Chinese officials are denying that they are silently limiting US$ withdrawals in China.

Moreover, China's top banking and insurance regulator CBIRC has quite aggressively warned investors from betting against the renminbi. Guo Shuqing, head of CBIRC, said in a speech that speculators "shorting the yuan will inevitably suffer from a huge loss." This almost threatening statement seems to be a desperate attempt by Chinese officials to limit capital outflows by foreign investors and traders.

China's increasing external debt, especially short-term debt, comes in a very bad moment, namely at the height of the trade war with the US and in a moment of slowing economic growth. The situations with the external debt make it increasingly difficult for China to counter US tariffs since it cannot afford to impose tariffs on the US without significant damage to the domestic economy. Moreover, if Beijing allows the renminbi to drop too much, Trump is likely to let the trade war escalate even further since he has for years denounced China's currency manipulation and the low renminbi.

Heijin's take on the situation in China is very bearish. China was famous for years for its low external debt and high FX reserves; however, this has changed since the Great Recession and creates is the source of big economic risks for China and the world. China's debt, both external and internal, has reached unsustainable levels that will inevitably lead to a downturn in the economic cycle. Beijing is aware of this and has tried with huge efforts to limit credit, especially China's shadow banking. The consequence of this was the weak economic growth in the second half of 2018, which made big headlines internationally. This, on the other hand, leads the Chinese government to loosen their credit requirements, which can be seen in the 6.4% GDP growth in the first quarter of 2019, which is largely based on the 5.1% debt ratio increase in the same period.

China has to face the decision between economic growth or economic stability. In the past years, Beijing tried to work towards economic stability; however, they seem not to be ready to accept lower economic growth. With the loosening credit standards in the past months, China has given a strong sign that it favours economic growth over economic stability, which will likely not work well in the long term. Sooner or later, the Chinese economy will have to face an economic cycle downturn like any other economy and the longer they postpone the downturn with loose money, the worse it will be.

Returning to the short-term perspective of China and its FX, we expect the renminbi to weaken in the upcoming two years; especially the USD-CNY pair will suffer. Moreover, we expect especially companies in the property market to take a big hit, since they have operated for years on high foreign debt levels. However, we are very cautious with our positions in regards to China's FX situation due to the fluctuating and unpredictable behaviour of the Trump administration.

Investment Analysis

Beyond Meat thinks it can go to the Moon, and beyond... (NASDAQ:BYND)

If you're a vegan or work in capital markets you will have probably already heard of Beyond Meat and the buzz-generating IPO it had at the beginning of May. With its initial IPO valuation of $1.5bn it raised $240m, but today Beyond Meat is worth almost $6.5bn. Yes, you read it correctly. So it is currently sitting at $104/share meaning it is almost trading at a 4.3x multiple in relation to its IPO price of $25/share. And these days when something trades at 4.3x its IPO value only 30 days later it is worrying in terms of what may happen next…

Short Summary on Beyond Meat's business:
Essentially Beyond Meat produces plant-based hamburger patties, sausages and crumbles. The company states that they want to create the future of protein, but what is funny is that their products are not actually that rich in protein relative to quantity and other nutrients when compared to normal real meat hamburgers (at this point someone may as well set up a Real Meat corporation).

Beyond Meat states that plant-based meats:
1) Improve human health (not necessarily true after having been analysed by nutritional experts)
2) Positively impacting climate change
3) Addressing global resource constraints
4) Improves animal welfare

And on top of that it also states some interesting figures, which are obviously in favour of their products:
- Animal-based meats have 16% and a 21% increased heart disease risk
- 51% of global greenhouse gas emissions driven by livestock rearing and processing
- 29% animal production and 45% global surface area for livestock systems
- 66 billion land animals slaughtered every year for food

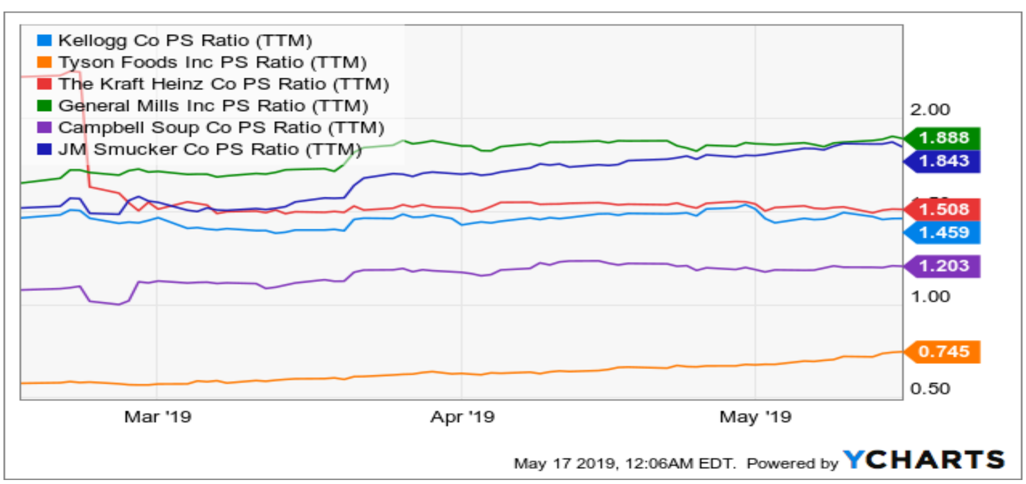
In order to best determine where Beyond Meat's share price is going, it's important to dissect the reasons behind this meteoric rise and to determine whether these may be factors that will propel Beyond Meat to an even higher level:

1) The vegan and/or vegetarian trend is spreading fast across the globe and people are beginning to take it very seriously in advanced economies. This stock pick was probably popular for millennials and the news coverage these days on "new foods" or "revolutionary environmentally friendly" goods is immense. Thus, Beyond Meat has chosen a great time to IPO and is riding shotgun in the vegan wagon. Despite all this, the amount of vegans in the U.S. is barely above 5% and the growth of that number is coming from the millennials and the Gen-Z. Overall the growth is steady, since after all when we take into account demographics, the younger generation is barely replacing themselves *fertility rate. Currently, in the U.S. the plant-based meats is an $11bn market of the top end range of estimates. Thus, to say that this industry will grow 15x its current size in just 10 years is slightly insane. Since this would imply a 30% annual growth compounded for 10 consecutive years.

2) On the most part, analysts have posted incredibly bullish comments and ratings on Beyond Meat. However, at today's valuation, some analysts are expressing concerning opinions on it. Prior to its IPO analysts on average estimated the industry to be valued at a potential $40bn in the next decade, but today they have upped that estimate to $150bn or more with no major additional reasoning whatsoever. All of this may be simple short term drivers to make sure the volume keeps the share price on its momentous rise. At $150bn potential market value then Beyond Meat's $6-10bn could to some extent be justified, but if they are not able to improve their profitability profile they will lose out to more profitable larger players in the food industry that will join in soon (giants Kellogg and Conagra have some subsidiaries that could put up a fight)… And then at that point, even today's valuation is not backed by rational growth figures on sales and margins in the long run.

3) It has been almost impossible to short this stock simply cause brokers either don't offer it or they are demanding incredibly high rates to short. A recent report estimated that short sellers have lost approximately $150m by trying to short Beyond Meat, which is obvious after taking a glimpse at how their share price has behaved. But, another reason for these losses is the fact that brokers allowing their clients to borrow shares to use to short sell are charging them berserk borrow fees (>60%). In fact, many brokers are charging borrow fees of 68% for BYND. This makes Beyond Meat the most expensive stock on any U.S. stock exchange to short - no surprise then that most institutional players have not even thought of shorting it after checking the borrow fees it would cost them. In the future, these borrow fees/rates should decrease to more reasonable levels whereby at that point institutional players would be willing to take up large short positions. In other words, because the stock is so hard to short (even via derivatives such as put options which are pricing in an absurd downfall) the share price is soaring higher and higher as the only sensible option here is to buy. Thus, when the playing field levels for short-sellers we believe that Beyond Meat will look at the past 30 days and refer to them as the "Good old days".

4) At the time of the IPO, the valuation metrics for Beyond Meat already showed an absurd profile but now it's becoming a joke. The stock is trading at a price/sales of >70, which puts it at least 3-4x above its competitors. And just to put things into perspective for techies who may think this is normal for a supposedly "revolutionary" company, UBER has a price/sales <9. We believe this says it all as the price/sales are serves as a useful valuation metric for food producers. The chart below shows the price/sales of Beyond Meat's main competition - that day is not yet direct competition, which is another factor they should be wary of.



5) Many investors and traders are betting big on the growth of Beyond Meat's business itself. And it is fair to say that in the past, the growth of their revenues has been very impressive. From 2017 to 2018 they posted revenue growth of 170% YoY, which is nothing short of staggering. Although, it is much easier to go from $32m to $87m in revenues than to go from $87 to >$200m. Their future growth depends on how fast they can capture market share and become a "brand" that is the standard for households when purchasing plant-based meat. Since some of their competitors, namely Impossible Burgers still do not have their products in stores such as Walmart, which Beyond Meat does. In other words, Beyond Meat has an average product in terms of nutrition but its good for the environment and they have been exemplary in setting up distribution channels. But, what investors need to ask themselves is what will happen when competitors put substitutes on shelves which are as good (if not better in taste, which apparently Impossible Burgers are) and at much lower prices…

Therefore, overall Heijin is very bearish on Beyond Meat for fundamental and technical (such as borrow fees which are making it near impossible to bet against) reasons. The stock may, of course, continue to rise, but it will not go much higher and if it does either people are braindead or we have overlooked something…

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