

Letter from the Field

Dear client,

You may have noticed we initiated positions in several Chinese stocks in the last couple of months. We believe China offers fertile ground for finding value. The Hong Kong stock market has consolidated for 20 years, while earnings of companies listed there have continued to grow. After purchasing Alibaba and BYD, we embarked on a three-week research trip that took us to the major cities, visiting many companies and local experts. Our understanding of how the country functions and where it stands expanded dramatically. Plus we encountered a few gems along the way.

Why we conduct research trips

When we invest, we buy pieces of businesses. To make sound investment decisions, we need to understand what these companies do, how they operate, and how their management think. Only then can we assess a business' earning power and how it should evolve over the long term—insights that form the foundation for determining whether we're getting more value than what we're paying for the stock.

There is no substitute for seeing things firsthand. Site visits enable deep conversations with management and employees on longer-term strategy, product development, production processes, and investment priorities. Exchanges with fellow investment managers we sometimes meet during these trips can provide additional perspectives that strengthen or question our investment thesis.

Site visits provide what spreadsheets can't—firsthand insight into operations, management thinking, earning power. We find it essential to assess the value of a business.

Is China investible at all?

The value from our recent China trip was greater than usual given China's governance system works completely differently to the Western countries to which we are accustomed. Understanding the chain of command, the incentives of top government officials, regulatory authorities, and local administrators—and how these can impact our businesses—is critical. In China, we must always remember that the government sits at the table.

This reality makes us even more selective than usual. We stay away from state-owned enterprises entirely as they are not run to maximize shareholder value. Among private companies, we have long focused on businesses whose success promotes the long-term aims of the central government. We now also understand we should favor businesses with interests aligned with local authorities.

In China, the government always sits at the table. We avoid state-owned enterprises entirely. Focus on private companies aligned with central government goals and local authority interests.

While President Xi may provide the long-term direction, in a country of China's size the execution is delegated to the provincial

governments. Provincial leaders are all outsiders to the region they are tasked to manage, their mandate does not exceed a couple of years, and promotion within the party ranks is highly dependent on economic KPIs.

The regulatory cycle and policy mistakes committed in the past few years were not caused by ideology, but are inherent to a system with long lags and imperfect feedback loops between the top and bottom of the pyramid, causing oversteering and subsequent correction. (*)

When optimism predominates, investors are well-advised not to focus solely on the country's development opportunities, but also to be mindful of the risks of operating in such a system. Likewise, when the regulatory cycle tightens and the market rhetoric is of a Chinese government filled with communists who do not understand business, investors should remember things are not as bad as then depicted. The CCP understands that its legitimacy mostly rests on its ability to develop the country.

When optimism predominates, be mindful of the risk. When pessimism takes over, remember that things are often not as bad as depicted.

Alibaba, back on track: A growing treasure

Understanding that reality increased our comfort in our Alibaba investment case. For two decades, the company was a juggernaut that built much of China's technological infrastructure (e-commerce, digital payments, cloud computing), becoming the embodiment of the government's ambition to develop world-class national technology capabilities.

Alibaba seems to find its bearing again after a tough period where it had to deal with a regulatory crackdown and emerging competition.

The regulatory crackdown that began in 2020 came after years of laxity. The CCP, focused on technological catch-up, let the Group companies operate freely—until excesses demanded correction. The crackdown decimated Alibaba's stock price. Authorities forced the cancellation of Ant Group's IPO and targeted practices deemed monopolistic. Growth also hit a wall, although this owed more to the law of large numbers than regulatory pressure—Alibaba serves over one billion consumers in China, leaving limited room for expansion, and competitors have since emerged to challenge its dominance. Albeit at lower pace, yet Alibaba never stopped growing and has always remained highly profitable. Recent initiatives have stabilized its competitive position, and management is returning substantial capital to shareholders through aggressive buybacks.

The rise of artificial intelligence as a national priority has placed Alibaba back at the center of the game. It operates the country's largest cloud computing infrastructure, and the capabilities of its large language model, Qwen, rival those of the US giants. Alibaba follows an open-source strategy that allows customers to develop derivative models tailored to their particular needs, addressing numerous industry verticals. Moreover, its AI infrastructure runs on ASIC chips developed by its in-house semiconductor unit, T-Head.

It is at the center of the AI game in China. Developing the infrastructure supporting AI has been established as a national priority by the government.

All of this positions Alibaba to scale its AI business at operating costs well below those of Silicon Valley. While Alibaba will spend about \$50

(*) *High Wire: How China Regulates Big Tech and Governs Its Economy*, Angela Zhang

billion on AI infrastructure over three years, Meta, Google, and Microsoft each plan to spend \$60 to \$100 billion annually. Whether through constraint or self-imposed discipline, Alibaba has learned to extract more from every dollar.

Economic situation: a tale of two Chinas

We toured a country that is charting a course between two opposing realities. On one hand, the Chinese economy faces headwinds. The property market is entering its fifth consecutive year of decline and continues to weigh on consumer confidence. The demographic challenge looms even larger: China's population is both contracting and aging rapidly, leading to potential GDP growth rates far below those the country experienced over the past four decades.

On the other, we witnessed extraordinary confidence and capability among Chinese enterprises. These companies have systematically mastered manufacturing processes that the West long ago surrendered. Starting with commodity components, they've moved up the value chain to produce complex components, advanced materials, and now entire finished products under their own brands. The Xiaomi factory exemplified this prowess: one complete electric vehicle assembled every 70 seconds with 90% automation. Throughout our visits, one theme emerged—the electronic products consumers worldwide depend upon simply cannot be manufactured without Chinese suppliers, making China an indispensable linchpin in global technology supply chains.

China's macro looks grim—property collapse, demographic crisis, slowing GDP. But walk into a factory and the story changes. Xiaomi's fully automated plant assembles an EV every 70 seconds.

BYD, driving the auto world in a new direction

BYD, in which we built an initial position earlier this year, exemplifies this well. The company started as a battery and electronic component manufacturer in the early 2000s. It has since become the largest electric vehicle producer on the planet. Its vertical integration strategy upends the traditional automotive business model—one built on coordinating hundreds of suppliers through the lean, just-in-time system Toyota pioneered to dominate the industry. BYD produces its own batteries (it holds the number two position globally), semiconductors, and nearly every critical component that goes into its vehicles. This control suits the new generation of automobiles well, as full EVs are radically simpler with far fewer parts. It is also made possible by BYD's scale and a degree of automation that exceeds its German and Japanese competitors.

While newspaper headlines focus on the company leapfrogging Tesla in EV sales, management confirmed during our meeting that their true ambition is to grab the torch from Toyota as the dominant player in the global auto market. The company is establishing production lines in Hungary, Indonesia, and Turkey, positioning itself to conquer international markets. We believe its standing as an integrated low-cost producer, its proprietary technologies, and its scale position it well to succeed.

What started as a battery manufacturer is now the world's largest EV producer. With their vertically integrated business model, BYD wants Toyota's global throne.

The domestic consumption shift

The officials we met appeared cognizant that the country has leaned on the success of tech companies and manufacturing exports more than was appropriate. Central government was happy to see exports drive GDP at a time of anemic growth, and local authorities required local banks to finance the investment of these companies, which replaced the tax revenue authorities could no longer attain from land sales. That has led to excess capacity that is feeding deflation.

These challenges won't be overcome overnight, and we think the speculation around the next stimulus is missing the point. Beyond flashy headlines, the government is multiplying the structural measures aimed at gearing the Chinese economy more toward domestic consumption and services. That was introduced for the first time in this year's Five-Year Plan. Child benefit and pension payouts have increased, minimum wages are being raised, and authorities are investing in healthcare infrastructure.

Domestic tourism is seen as an important area of focus, with local governments encouraged to develop events that would stimulate in-country travel. The high-speed rail network—already the world's most extensive—continues to expand, making travel between cities faster and more affordable than ever. During our trip, we experienced this infrastructure firsthand, travelling between Beijing, Shanghai, and Hangzhou in comfort that rivals business class air travel.

H World, uncovering a gem

This brings us to one of the gems we uncovered in China: H World, one of the largest hotel operators in the country. Lodging is not only seen by local authorities as a way to generate tax revenue, but it also conveniently absorbs some of the excess property capacity. H World is positioned to benefit from Chinese consumers' growing appetite for domestic travel.

What impressed us most was seeing its business model come alive. We met with dozens of hotel managers and owners across Beijing, and the high profitability, high return on capital formula was evident at every stop. Founder Ji Qi—also a co-founder of Trip.com—established a distinctive approach: asset-light 'managization' of hotels. Owners invest in the property and cover all operating and capital expenses. H World provides the brand, the systems, the operational know-how, and even the general manager—who is invoiced to owners at a markup. The result is a model that scales rapidly without tying up capital, while generating multiple revenue streams.

For an owner, onboarding onto the H World platform means benefiting from lower development costs and guaranteed traffic. The cost advantage comes from scale. H World's 12,000 hotels give it enormous purchasing power, which it deploys through a tightly

Overcapacity crisis gradually forces rebalancing. The government is introducing measures to advance structural reforms that expand domestic consumption and cultivate a services-oriented economic model.

H World, one of China's largest hotel operators, benefits from the structural growth of domestic travel and local government push to absorb excess property capacity.

controlled supply chain. Room modules, equipment, and consumables are standardized across the portfolio, allowing suppliers to deliver at volumes that dramatically lower costs for hotel owners. Being on-boarded as an H World supplier is a game-changer, guaranteeing access to thousands of properties. H World even coordinates logistics, directing suppliers where to locate distribution centers based on hotel density. The cost savings flow back to franchisees, shortening payback periods to three to five years.

H World has a highly profitable and asset light business that grows stronger as it scales.

The traffic advantage comes from H World distribution reach. Nearly 60% of bookings come through its direct membership channel, meaning owners who join the network gain immediate access to a steady stream of customers that do not book through the expensive platform like Trip.com. For a new hotel owner, this de-risks the investment considerably: they get a recognized brand, guaranteed occupancy, and turnkey operations from day one.

Underneath it all sits proprietary technology infrastructure—cloud-based property management, centralized reservations, and shared service centers—that binds the network together and keeps it running efficiently.

Investors willing to search where few others do, can buy the stocks of highly profitable and fast-growing businesses like H World at prices offering high returns.

Conclusion

Despite all its difficulties, we believe the progress achieved by China is here to stay and that the country's manufacturing capabilities, infrastructure, and increasingly sophisticated companies will continue to drive value creation. The current pessimism has created a rare opportunity to buy excellent businesses at compelling valuations. We remain selective, focusing on companies with strong governance, alignment with government priorities, and genuine competitive advantages.

Regulatory uncertainty, geopolitical tensions, and domestic economic challenges may create volatility, but for patient investors willing to look beyond the headlines, China offers opportunities that are increasingly scarce in richly valued Western markets. We will continue to maintain positions in businesses we understand well, where we believe the margin of safety is substantial.

Sincerely yours,

Cedric Jacque, CFA

Senior Portfolio Manager



"Kicking the tires" — Peter Lynch

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