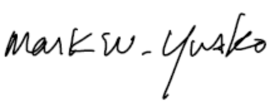
MORGAN CREEK
CAPITAL MANAGEMENT

ALTERNATIVE THINKING ABOUT INVESTMENTS

New China Perspectives

Welcome to the weekly issue of Morgan Creek's ***New China Perspectives****. It is comprised of research from Morgan Creek's China-based investment team together with curated articles of interest. In addition to timely political and economic news covering greater China, Morgan Creek's China team seeks to provide in-depth perspectives on investing in the technology, consumer and healthcare sectors in the region. Our research leverages the "on the ground" insights of our team together with Morgan Creek's decades-long experience in covering the region. Our team are focused, thematic investors primarily covering the technology, consumer, and healthcare sectors and investing in private companies and early-stage managers with deep local expertise. To learn more about our team and investment offerings, please email chinateam@morgancreekcap.com.*

Best Regards,



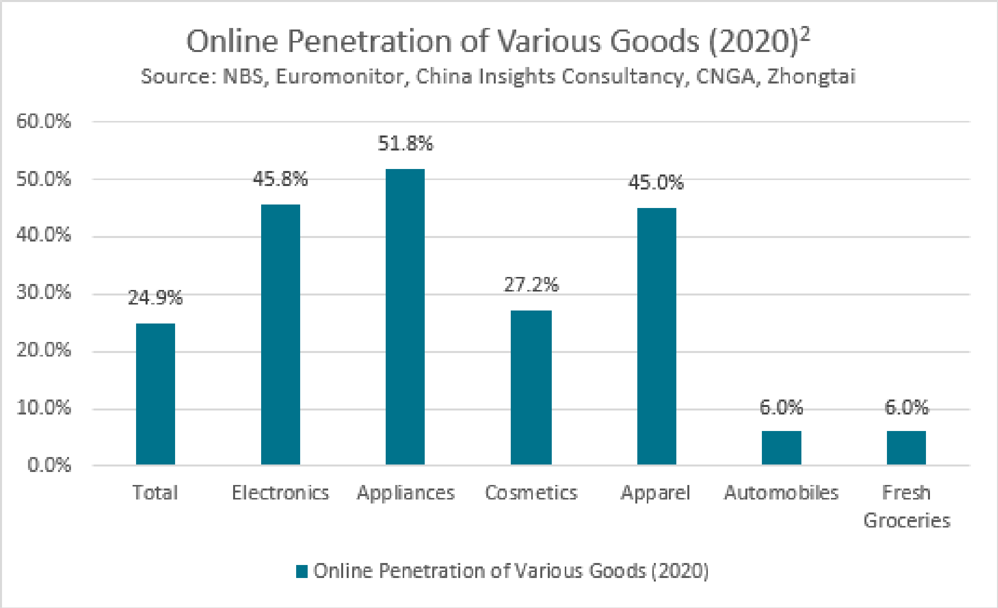
Mark W. Yusko
CEO & CIO

NOTES FROM THE BUND[1]

This is the last issue on Meituan, and we will discuss a final (potential) revenue driver in its innovation businesses bucket – community group buy and grocery delivery to the home. In this newsletter, we will discuss:

- Fresh grocery industry and its importance to tech giants
- Various ecommerce business models, including community group buy which is the fastest growing
- Meituan's interest in community group buy

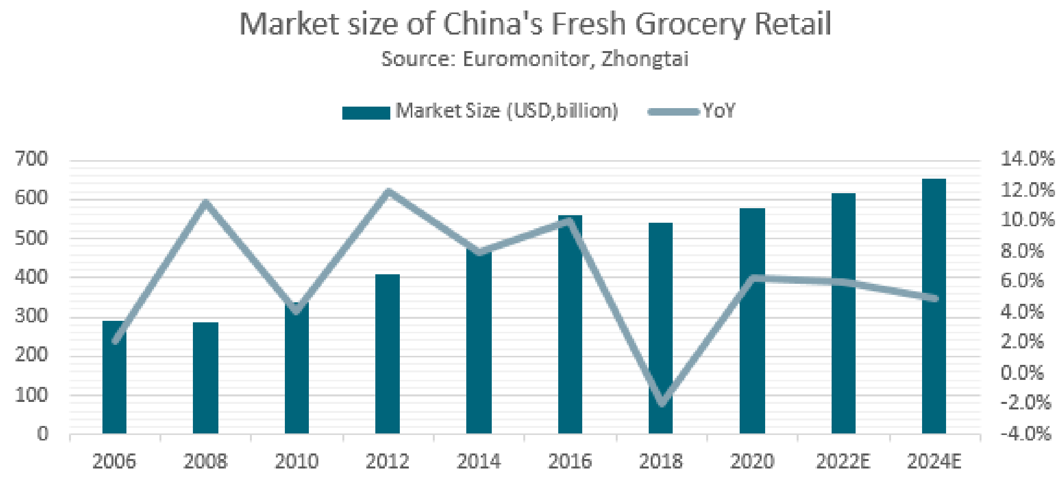
Fresh grocery is among the last arenas in China where the ecommerce giants are competing, but have not had significant market penetration. (Automobiles too, however that is another story.)



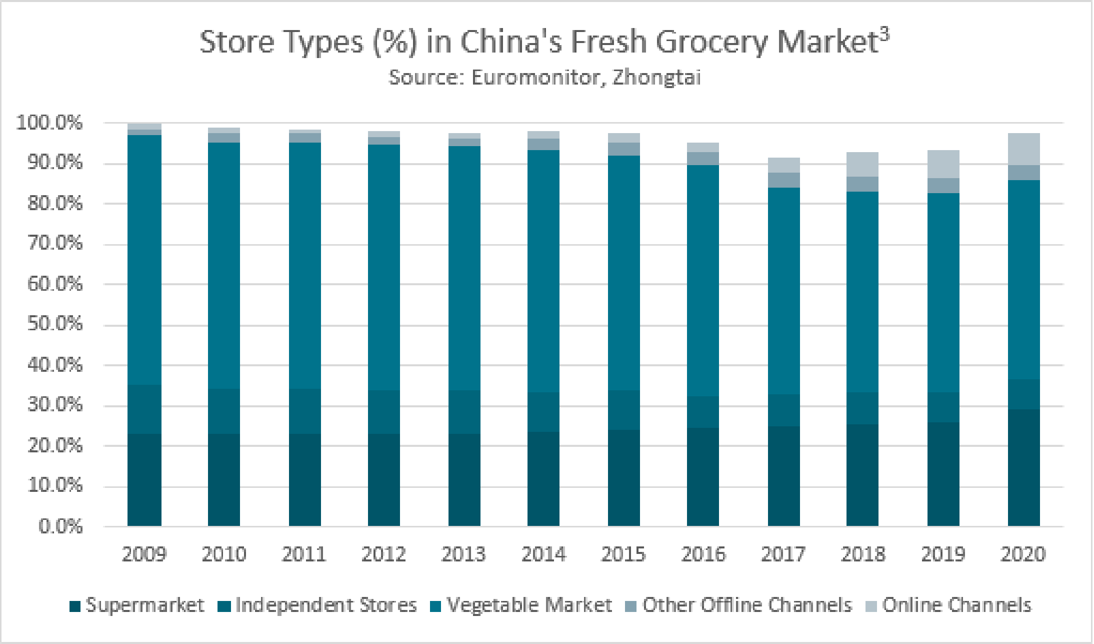
There are multiple reasons why ecommerce penetration in fresh groceries is low:

- it is a perishable good so needs to be sold within a few days
- the product is not standardized, so it is difficult to ensure consistent quality of produce
- logistics are expensive with cold chain required
- groceries tend to be regional given different tastes from province to province
- for all these reasons, margins are very low for fresh produce and for all platforms this is typically a money losing endeavor

Groceries, however, are a high frequency purchase (and is a staple, or “□□”), therefore it has the potential to bring much traffic and retention to ecommerce platforms. It provides significant strategic importance to consumer tech giants who want to increase and/or retain users on their platform. This logic is similar to supermarkets, which typically do not make much selling groceries yet do so as a loss leader to attract customer flow.



The size of the grocery market is huge and ecommerce penetration in fresh grocery today is around 6%. Distribution remains very fragmented, with the traditional wet markets channel taking almost 50%, followed by supermarkets at close to 30%.



Within ecommerce, ecommerce giants are testing multiple business models:

China Fresh Produce E-commerce Players

Mainstream Fresh Grocery E-commerce business models: diversified & more trials on the way					
	Alibaba	**JD**	**Meituan**	**PDD**	**Other Start-ups**
Traditional E-commerce[4]	Tmall Fresh (merged with Freshippo)	JD Fresh	——	PDD platform	——
O2O platform[5]	Taoxianda, Eleme New Retail	JD Daojia	Meituan Shangou (flash purchase)	——	Duodian
Frontline fulfilment stations[6]	——	——	Maicai	——	Dingdong, Missfresh, Pupu (regional)
In-store & Delivery[7]	Freshippo	7fresh	——	——	——
Community Group buy[8]	Taocaicai	Xingsheng Youxuan (regional)	Meituan Youxuan	Duoduo Maicai	——

- The two models that are growing the fastest are front warehouse model and community group buy, which is estimated to account for ~40% of ecommerce distribution in 2021
- Of the two, the volume of produce moved through group buy is 4x that of the front warehouse model, and the two companies that currently own 2/3 of that community group buy market are Meituan and Pinduoduo.

<u>2021 China Community Groupbuy Market Share</u>

	2021 annual gross GMV	2021 cash burnt	2021 OCF/FCF
Meituan	RMB 120 Billion	RMB 30 Billion	RMB 117 Billion/(13 Billion)
PDD	RMB 80 Billion	RMB 10-13 Billion	RMB 93 Billion/26 Billion
Xingsheng	RMB 1.2 Billion		
Taocaicai	RMB 200 Million		

Meituan is currently the leader of the pack with the highest Gross Merchandise Volume ("GMV") last year; however, it has also burnt the most capital among its peers to achieve that market share. The chart below describes the key differences between the two models, and explains why there are more synergies for Meituan in its warehouse model as compared the community group buy model.

Differences in The Substances of 2 models		
	Front Warehouse	Community Group buy
Merchandizing Model	Proprietary Trading	Consignment
Source	Direct purchase	Local wholesaler
Time to fulfill the order	30-40min, immediate demand	Next day, scheduled demand
Distribution	Delivery	Self-pick-up at the group buy coordinators
SKU	~4,000; can fulfill most basic needs	~500-1,000; barely cover basic needs
Order size	RMB 60~100	RMB 15~30
Cost to fulfill the order	RMB 20~25	Warehouse cost, RMB~1 per order
Fresh Grocery % of total GMV	~60%	~33%
Targeting customers	Those who favor convenience and quality	Those who favor low prices
Area	Tier-1 & Tier-2 cities	Lower-tier cities and remote area

The front warehouse model is an asset intensive model where platforms build/rent warehouses close to customers and take ownership of inventory and cold chain delivery to allow them to offer choice (significantly more SKUs), quality and speed of delivery to their customers. Community group buy on the other hand offloads the heavy lifting to a group leader who aggregates orders, acts as the fulfilment, and pick up center, cutting last mile logistics costs. This model serves customers who place less value on convenience (delivery comes a day after placing the order) and choice (much less SKUs available) for dramatically lower prices. As such, there are few synergies this model has with Meituan's existing customer and merchant base:

- User base – community group buy model tends to attract users in lower tier cities, where price is a major consideration for users. Meituan's existing user base tends to reside in the higher tier cities and have the ability and willingness to pay for convenience (*i.e.*, for food delivery) and higher end services (*i.e.*, hotel accommodations). Meituan thus views this business line as an opportunity to increase its user base, and therefore is willing to pay more for customer acquisition via higher commission sharing with its "group leaders". Its leading competitor, Pinduoduo ("PDD"), on the other hand already has an existing profitable

business catering to this user demographic and is able to do much cross selling (~60% of PDD's users overlap with their grocery business) and thus has a lower cost structure.
- Merchants/service providers – There are limited synergies between Meituan's existing business (servicing service merchants like restaurants, hotels, salons, etc.) and servicing group leaders who sell products. The latter requires significant investment in building and operating a logistics network, which is a new endeavor for Meituan.

While community group buy remains currently a small proportion of Meituan's overall revenue (estimated 4% of total revenue in 2021), it is expected to grow quickly given the tremendous size of the fresh foods business. More importantly, it allows Meituan to potentially expand its user base into the lower tier cities (which currently do not have the capacity to purchase its other existing services) and prevent other tech giants (especially PDD) from fully consolidating the entirety of the lower tier markets, after which they will then likely move upmarket to become a threat to Meituan. The importance of this to Meituan is shown by the amount of capital they have burnt – RMB 38.4 billion, or $6 billion into the community group buy business. To cut down on burn, Meituan has decided to focus on utilizing the front warehouse model in first and second tier cities, community group buy model in third and fourth tier cities, and withdraw from fifth tier cities. We are still in the early innings of this game and it will be interesting to see how the landscape will continue to evolve.

Click here to see back issues of New China Perspectives

CHINA NEWS SPOTLIGHT

China IPO Applications Jump, Bucking Global Trend, as COVID Curbs Ease: A spike in listing applications from Chinese companies in June has nearly doubled China's IPO candidates to almost 1,000, the highest in at least three years, potentially making the country a bright spot for bankers as equity offerings slow in other markets. *Read More.*

China's June Factory Inflation Cools Counter to Global Trends: China's factory-gate inflation cooled in June to the lowest in 15 months as the country continues to buck the global trend of accelerating prices. *Read More.*

China Starts to Pull Cash in Pivot From Crisis Policy Easing:
China's central bank looks set to withdraw cash from the financial system in a sign that it's moving toward normalizing monetary policy as major global peers are forcefully raising interest rates. The People's Bank of China slashed its daily short-term liquidity operation to 3 billion yuan ($447 million) this week, the smallest amount since January 2021. At this pace the central bank removed more cash in the first five sessions of this month than it injected toward end-June. *Read More.*

China Tech Stocks Sink as Alibaba, Tencent Suffer Fresh Fines: Chinese tech stocks fell sharply Monday, weighed by a selloff in Alibaba Group Holding Ltd. and Tencent Holdings Ltd. after the two firms received a regulatory fine on past transactions. The Hang Seng Tech Index dropped as much as 3.7%, with Alibaba among the top losers after plunging 6%. Tencent fell a maximum of 3.2%. *Read More.*

Shenzhen Unveils China's First Legislation on Supporting L3 Autonomous Driving: The Standing Committee of Shenzhen's Congress promulgated an announcement entitled Regulations of Shenzhen Special Economic Zone on the administration of intelligent networked vehicles (referred as to the "Regulations"). This legislation, considered as the first domestic regulation on the management of intelligent connected vehicles, clearly stipulates that intelligent vehicles are allowed on the roads with prerequisites of registration certificates, license plates, and driving licenses. *Read More.*

Huawei AITO M7 SUV Orders Crossed 10000 within Two Hours of Launch: Huawei launched the AITO SUV M7 car at Summer new product launch conference and unveil its extraordinary feature to make your life more comfortable and luxurious. With the consumer's love and support, the company reaches over 10000 orders of Huawei SUV M7 soon after its launch. As expected Huawei AITO SUV M7 aims to bump the entire AUTO market and here a result within two hours of booking Chinese tech giant take orders exceeding 10,000 reservation by consumers. *Read More.*

COVID and Bust - China's Private Health System Hurt by Tough Coronavirus Controls: On March 24, a court in the central Chinese city of Fuyang announced that a $1.5 billion hospital built just four years earlier had filed for bankruptcy because it was unable to pay its debts. *Read More.*

Junshi Biosciences and Coherus Announce FDA Acceptance of Resubmission of BLA for Toripalimab for the Treatment of Nasopharyngeal Carcinoma: Shanghai Junshi Biosciences Co., Ltd. ("Junshi Biosciences", HKEX: 1877; SSE: 688180) and Coherus BioSciences, Inc. ("Coherus") announced today that the United States Food and Drug Administration ("FDA") has accepted for review the Biologics License Application ("BLA") resubmission for toripalimab in combination with gemcitabine and cisplatin as first-line treatment for patients with advanced recurrent or metastatic nasopharyngeal carcinoma ("NPC") and for toripalimab monotherapy for the second-line or later treatment of recurrent or metastatic NPC after platinum-containing chemotherapy. *Read More.*

[1] The Bund is a historic waterfront area in central Shanghai, where Morgan Creek's office is located. From the 1860s to the 1930s, it was the rich and powerful center of the foreign establishment in Shanghai, operating as a legally protected treaty port. The picture above is part of the historical waterfront.

[2] Sources: The online penetration data of different category of goods are sorted from regular releases and reports from various institutions including National Bureau of Statistics, Euromonitor, China Insights Consultancy, China National Garment Association, Zhongtai Securities.

[3] Source: Euromonitor, Zhongtai Securities

[4] B2C in E-commerce: B2C, or business to consumer, is the type of commerce transaction in which businesses sell products or services directly to consumers via shopping platforms like Amazon in US, or Taobao in China.

[5] O2O: Online-to-offline (O2O) commerce is the business strategy that draws potential customers from online channels to make purchases in physical stores. It identifies customers in the online space, such as through emails and Internet advertising, and then uses a variety of tools and approaches to entice the customers to leave the online space.

[6] Frontline Warehouse: The "frontline fulfillment grid model" is a warehouse distribution model in which each store is a small to medium-sized warehouse distribution center, which allows a large central warehouse at headquarters to supply only to the stores and to cover the last mile. Compared with the offline retail store model, the frontline fulfillment grid model is less dependent on-site selection and front-end operators, thus has faster inventory turnover and greater scalability in terms of rapidly addressing new regional markets and user demographics.

[7] In-store & delivery: This model is a combination of store and warehouse. The front store is both a retail store and takes on the function of online storage and distribution. Consumers can go to the physical store for in-store shopping and place orders through the online platform, which provides delivery to home within one hour, serving users in the 1-3 kilometers around the center of the store.

[8] Group buy: This business model allowed community groups to buy groceries and other daily essentials in bulk at cheaper prices than if members made individual purchases.