KRANESHARES FLASH REPORT

China internet 2015 & beyond + an overview of 2014 results
For years China’s economy has been shifting away from export-driven, manufacturing-based growth and moving towards self-sustained, consumer-driven development. China has learned from the economic development of its predecessors and is leap-frogging unnecessary brick and mortar infrastructure with internet and technology solutions. It is our opinion that China internet companies represent the foundation of China’s new economy, and their global influence will rival or exceed that of Facebook, Google, and other leading technology companies.

**KraneShares believes the following recent developments will allow China internet companies to deliver attractive total returns compared to U.S. internet companies and broader emerging markets equities in 2015.**

- China’s government announced renewed support and investment in China internet companies.
- MSCI is adding China internet companies to MSCI ACWI and MSCI Emerging Markets, reallocating billions of global investment dollars into China internet companies.
- China internet companies continue to deliver outstanding earnings driven by increases in China’s overall internet user base, new client acquisition, and increased market share of total retail consumer spending.

**2015 & Beyond:**
What is to come for the China internet sector in 2015 and beyond?

**China’s government announces renewed support and investment in China internet companies.**

The National People’s Congress (NPC) began on Thursday March 5th. The NPC is held every spring and typically lasts 10–14 days. During the event, China’s leadership makes major policy announcements regarding the future of key sectors in its economy. The announcements made at the event are followed closely by global markets as they reflect the future direction of the world’s second largest economy.

At this year’s NPC, Premier Li Keqiang announced particularly supportive measures to expand China’s internet sector.
Premier Li stated that China will back e-commerce development and guide international expansion by China internet companies. Li broadly laid out China’s “Internet Plus” strategy, which includes promoting cloud computing, online banking, mobile internet, along with logistics for e-commerce expansion. He also stressed the need for more state investment in the internet sector. Commenting on government investment in the China internet sector, Premier Li stated:

“In addition to the 40 billion yuan ($6.38 billion) government fund already in place for investment in China’s emerging industries, more funds need to be raised for promoting business development and innovation.”

**MSCI is adding China internet companies to MSCI ACWI and MSCI Emerging Markets, reallocating billions of global investment dollars into China internet companies.**

MSCI, a leading provider of index solutions globally, will be enhancing its index coverage in November 2015 to add foreign listed companies to both MSCI Global Indexes and MSCI Country Indexes. This change will be particularly relevant for foreign listed Chinese companies especially since China internet companies have a penchant for listing in the United States due to the belief they can attract a bigger international investor base through a U.S listing.

The announcement comes after the China-based e-commerce giant Alibaba held its initial public offering in the United States. Alibaba’s IPO was the largest ever in the U.S., bringing increased media and investor attention to the gap in MSCI’s current definition of China, which currently only includes Hong Kong listed Chinese companies.

The importance goes beyond investors with dedicated China allocations as the definition of China rolls up into indices like MSCI Emerging Markets and MSCI All Country World Index. Our calculations show that over $10 billion would be added into these securities based on index funds and ETFs benchmarked to MSCI ACWI, EM and Asia indices. Beyond passively managed index funds and ETFs, there are seven times as many assets benchmarked to these indices by active managers. This could mean billions more inflow into the China internet companies listed in the United States that the KraneShares CSI China Internet ETF (ticker : KWEB) holds today. MSCI has proposed a two stage inclusion process beginning with stage one this November followed by stage two in February 2016.

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1.) Investopedia, “Top 10 Largest Global IPOs Of All Time” 01/12/2015.

2.) Based off assets benchmarked to MSCI indices as of June 30, 2014, as reported on September 30, 2014 by eVestment, Morningstar and Bloomberg. The institutional/retail split is based on eVestment and Morningstar database classification. Data excludes futures and options.
China internet companies continue to deliver outstanding earnings driven by increases in China’s overall internet user base, new client acquisition and increased market share of total retail consumer spending.

On February 3rd 2015, the China Internet Network Information Center (CINIC) reported that the internet population within China increased by 31 million users to 649mm in 2014, representing 48% of its total population. In comparison the United States had 279mm internet users by the end of 2014 representing 87% of its total population. Based on this comparison, the China internet sector has room to grow.

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1.) China Internet Network Information Center’s February 3, 2015 “35th Statistical Report on Internet Development in China”
2.) Source: internetlivestats.com as of 12/31/2014
As China’s internet population expands, companies within the sector continue to develop products and services to capture the growing market. Below we have summarized the 2014 results of key China internet companies that have reported to date.

**Tencent (10.67% of KWEB net assets as of 2/28/2015*)**

Although China internet giant Tencent is listed on the Hong Kong Stock Exchange, which may make the company less-known to U.S. investors than some of its New York listed counterparts, like Alibaba and Baidu, we believe its size and growth should place it firmly on the radar of U.S. investors. We identified four key drivers from Tencent’s recently reported year-end and Q4 2014 results that position the company for success. These four factors will help U.S investors better understand what makes Tencent’s massive online ecosystem tick.

**Holiday Promotions**

One particularly successful new business development for Tencent came during the 2014 Lunar New Year celebration when the company introduced a feature on its WeChat platform that brought the ancient tradition of giving red envelopes filled with cash into the digital age. On Lunar New Year’s Eve, February 18, WeChat users exchanged a total of 1 billion virtual red envelopes¹ on the platform. It is estimated that the promotion attracted 100m-200m new clients (and their bank account details) to WeChat.¹

**Partnerships**

Tencent found additional success in 2014 by partnering with other China internet firms to provide services to its users that extend beyond its core offering. This “Connection Strategy” helped drive WeChat’s 500mm desktop and 815mm² mobile users to a variety of destinations and content partnerships within its ecosystem. Some destinations include, JD.com for e-commerce, BitAuto for car sales, and Leju for real estate, online video and gaming. The “Connection Strategy” also includes exclusive content partnerships with foreign companies including the NBA, HBO, and Sony Music.

**Advertisement**

Tencent aims to further monetize its growing user base by expanding its burgeoning advertising platform. We believe this presents a strong revenue gathering opportunity for Tencent. To put the opportunity in perspective, in 2014 Facebook derived 95% (12.5 billion)⁴ of its revenue from advertising sales while Tencent only derived 11% ($1.3 billion)⁵ of its revenue from ad sales. Advertisement has the potential to become a major driver of revenue growth for Tencent in quarters to come.
Tencent by the numbers:

- Q4 revenue increased 24% to $3.428 billion
- 2014 revenue increased 31% to $12.899 billion
- Gross margin was 60.3% in Q4
- Diluted EPS increased 54% in 2014 to 2.545 renminbi (RMB)
- Free Cash Flow* increased 76% in Q4 to $1.482 billion and 45% in 2014 to $4.514 billion

Tapping a new shareholder base

The Shanghai-Hong Kong Stock Connect Program not only allows foreign investors to directly purchase stocks listed on the Shanghai Stock Exchange for the first time, it also works the other way, giving mainland investors access to the Hong Kong Stock Exchange for the first time as well. To phrase the opportunity in terms of U.S. companies, imagine if investors were given the opportunity to invest in Apple or Google for the first time after using their services for years, there would undoubtedly be pent up interest. This is the sentiment many mainland investors have toward buying Tencent shares for the first time. Tencent’s strong stock performance can partially be attributed to pent-up mainland investor demand.

* 1.) Z-BEN ADVISORS prediction as reported by the Financial Times, “Tencent beats Alibaba in ‘red envelope’ app war” 2/27/2015
2.) Tencent 2014 Fourth Quarter and Annual Results
3.) Financial Times “Tencent launches China’s first online-only bank” 01/05/2015
4.) Adweek “Facebook’s Q4 2014: Mobile is Now 69% Of Ad Revenue” 01/28/2015
5.) Bloomberg “Tencent Climbs as Ad Surge Boosts WeChat Earnings Outlook” 03/18/2015
6.) Free Cash Flow: A measure of financial performance calculated as operating cash flow minus capital expenditures. Free cash flow (FCF) represents the cash that a company is able to generate after laying out the money required to maintain or expand its asset base. Free cash flow is important because it allows a company to pursue opportunities that enhance shareholder value.

JD.com (8.5% of KWEB net assets as of 2/28/2015*)

JD.com is an Alibaba rival that ramped up expansion in 2014 through enhanced logistics and collaboration with other China internet companies. Last March, JD entered into a partnership with China social media giant Tencent to leverage the firm’s ubiquitous WeChat messaging system to promote its online store.

Investors in the U.S. are quick to make comparisons between Alibaba and Amazon. In reality, JD resembles Amazon more closely than Alibaba because the company owns its logistics, warehouses, and delivery network for goods purchased on its e-commerce platform.
They use this advantage for quicker and more reliable delivery times. JD’s streamlined logistics and partnership with Tencent is gaining the company market share in the mainland China e-commerce space.

JD is a fast growing company though not quite profitable. Going into its Q4 and 2014 annual earnings release, investors were focused on the monetization of the Tencent partnership.

Below we have summarized a few Highlights from Q4 and 2014 annual earnings

• Gross merchandise value – GMV (value of goods sold on JD.com) increased 119% to $13.8 billion from Q4 2013 to Q4 2014, while annual GMV rose 107% to $41.9 billion.

• Net revenues rose 73% to $5.6 billion from Q4 to Q4, while for the year it rose 66% to $18.5 billion.

• Number of orders increased 95% to 217mm from Q4 to Q4, while for the year the number rose to 689mm from 323mm.

• JD had a Q4 net loss of $73.2mm though non-GAAP net income was $13.5mm. The net loss was due to “amortization of intangible assets...related to the Tencent partnership.” For the year, the net loss was $800mm due to “the increase in share-based compensation expenses...amortization of intangible assets...related to the Tencent strategic partnership.”

While JD fell short of achieving profitability the company made key strategic moves to position themselves to gain market share. Management’s guidance for Q1 2015 revenue was +50% from Q1 2014. The stock rallied on the news. One interesting note in the earnings release was JD’s exclusive e-commerce partnership with Maotai, a popular brand of baijiu (China’s distilled spirit of choice) leading up to the Chinese New Year. It will be interesting if JD finds similar success with new initiatives to sell increasingly popular French champagne and American sparkling wine in the years ahead.

Alibaba [8.3% of KWEB net assets as of 2/28/2015*]

While Alibaba had a great quarter increasing sales and earnings 39% and 32% year over year (YoY) respectively, the stock sold off. The main culprit was a shortfall on net income due to $690mm share based compensation expense. Additionally, Alibaba’s mobile monetization rate was less than it’s non-mobile rate.

• Gross Merchandise Value (GMV) increased 49% YoY to $127 billion

• Active Users increased 45% YoY to 334 million
• Quarterly Revenue increased 40% YoY to $4.2 billion
• Mobile GMV increased 213% YoY to $53 billion while mobile revenue increased 448% YoY to $1 billion
• Free Cash Flow increased to $3.66 billion

**Baidu** *(7.3% of KWEB net assets as of 2/28/2015)*

Baidu similarly had a great quarter though the mobile monetization rate came in light as well. Baidu reported results from their fourth quarter and fiscal year 2014 on February 11th, 2015.

• Total revenues for the quarter increased 47.5% to $2.26 billion YoY
• Operating profit for the quarter increased 7.8% to $475 million YoY
• 2014 annual revenues increased 53.6% to $7.9 billion from 2013
• As of December 31, 2014 the company had cash, cash-equivalents and short term investments worth $9.295 billion

Like Alibaba, Baidu’s stock sold off on the lighter than expected mobile monetization rate. However, as long term investors in both companies, we are encouraged by the strong results and framework for future mobile expansion.

**Netease** *(6.2% of KWEB net assets as of 2/28/2015)*

Netease, one of China’s premier online gaming companies, had a strong fourth quarter and 2014. On February 9th, the company released their results which showed 2014 revenues grew 27.7% year over year while fourth quarter revenues increased 42.5%. EPS increased to $5.85 in 2014 from $5.64 in 2013. Netease made $767 million in net profits in 2014 selling online, mobile and PC games. We often speak to the growing predominance of smart phones as the sole source of household entertainment in China, Netease is capitalizing on this trend with an increased focus on mobile game development.

**Vipshop** *(4.7% of KWEB net assets as of 2/28/2015)*

VIPS, China’s leading online discount retailer, reported their Q4 and 2014 earnings on February 16, 2015. It was both a very strong quarter and year as the company grew revenue to $1.3 billion, up 109% YoY. As active users doubled to 12.2mm from 5.7mm. Net Income jumped from $25mm to $56mm from Q4 2013 to Q4 2014 while on an annual basis it jumped from $52mm to $137mm. Total orders increased 118%
from 49mm to 107mm. One notable aspect of VIPS reporting was the company’s compelling articulation of their opportunity set within the broader China e-commerce landscape.

**Ctrip** [4.22% of KWEB net assets as of 2/28/2015*]

China’s tourism market has been expanding steadily due to its citizens’ growing penchant for domestic and international travel. Ctrip has established itself as a stand-alone leader in the online booking space, offering services akin to Travelocity or Kayak here in the U.S.

Despite the backdrop of growing Chinese tourism, as evidenced by the 20mm trips booked on their website in 2014¹, Ctrip’s stock lagged as the company used profits to invest in expanding technology necessary for growth.

- Total revenue in Q4 grew 32% to $308mm while 2014 total revenue grew 36% to $1.2 billion.

Ctrip’s stock soared by over 20% on March 20th² following their earnings announcement the previous day when results and guidance exceeded analyst expectations. The company’s stock suffered previously from heavy shorting in the market place by at least 10 million shares at the end of February². As the stock price soared on March 20th short sellers were forced to liquidate their positions at progressively higher prices as the stock moved up rapidly.

¹) Ctrip’s Unaudited Fourth Quarter and Full Year 2014 Financial Results
²) Data from Bloomberg as of 3/24/2015

**Autohome** [2.2% of KWEB net assets as of 2/28/2015*]

China’s auto sector is small relative to the size of their population though it is growing at a rapid rate. According to Bloomberg, 23mm vehicles (auto and commercial) were sold within China in 2014, which accounts for 59% of all sales in Asia and more than all European vehicle sales (16.2mm). Autohome calls itself “the leading online destination for automobile consumers in China”. The company has benefited from the increased demand for cars and SUVs from China’s growing middle class. The company had an outstanding Q4 and 2014:

- Q4 2014 net revenue grew to 91.5% to $119mm while net income grew 103.4% to $40.2mm versus Q4 2013.

- 2014 net revenue grew to 75.3% to $343.8mm while net income grew 64.1% to $120.7mm versus 2013.

*Holdings are subject to change.
Visit www.kraneshares.com/kweb for most recent holdings
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KWEB invests in variable-interest entities (VIEs), which are investments in foreign-domiciled American Depository Receipts (ADRs). Rather than owning Chinese-domiciled entities, the VIEs have contractual arrangements designed to provide the economic benefits related to certain Chinese-domiciled companies. The structure of VIEs presents some unique risks that should be considered.

VIE structures do not give investors ownership in the operating company, as stock does. With a VIE, an investor has no direct claim on the core, restricted business assets of the VIE operating company. As a result, investors may not exert as much influence over the subject company as they could if they were owners of common stock. Often, the voting rights in the VIE operating company, especially in matters of corporate governance, are controlled by the principals who established the VIE operating company.

In addition, there is no guarantee as to the enforceability of the VIE structure, as it has never received explicit approval from the Chinese government and is recognized as a structure put in place principally to work around Chinese restrictions on foreign investment.
Carefully consider the Funds’ investment objectives, risk factors, charges and expenses before investing. This and additional information can be found in the Funds’ prospectus, which may be obtained here: kraneshares.com

Investing involves risk, including possible loss of principal. There can be no assurance that a Fund will achieve its stated objectives. The Funds focus their investments primarily with Chinese issuers and issuers with economic ties to China. The Funds are subject to political, social or economic instability within China which may cause decline in value. Fluctuations in currency of foreign countries may have an adverse effect to domestic currency values. Emerging markets involve heightened risk related to the same factors as well as increase volatility and lower trading volume. Current and future holdings are subject to risk.

Narrowly focused investments typically exhibit higher volatility. Internet companies are subject to rapid changes in technology, worldwide competition, rapid obsolescence of products and services, loss of patent protections, evolving industry standards and frequent new product productions. Such changes may have an adverse impact on performance.

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