LIGHTHOUSE ADVISORS
Keeping Your Capital Safe

91 Club Street
Singapore 069459
Tel (65) 9040 9813
Fax (65) 6423 4421
www.lighthouse-advisors.com

Client Newsletter for the period ended 30 June 2009

1. Foreword

Fellow Investors,

Welcome to the Lighthouse Advisors newsletter for June 2009. This marks the third quarter of operations.

This newsletter follows the same format as previous issues. The special topic for this issue is **Trade Receivables**.

2. Market Commentary

The world economy remains mired in recession. Recent indicators suggest some economies have begun to stabilize, but for the most part, things are only getting worse more slowly. The recovery will be slow and uneven.

US unemployment hit 9.5% in June, the worst since August 1983. The 20-city Case-Shiller index of US home prices was 18.1% down in April against the year before. Phoenix and Las Vegas are the worst-hit, having fallen over 50% from their peaks. Nationally, prices are back at mid-2003 levels. In Detroit, heart of the American automotive industry, they are at mid-*1995* levels. Furthermore, Chrysler and General Motors are in Chapter 11 bankruptcy restructuring; it is a given that they will shrink their workforces and worsen unemployment.

America now faces a financial paradox: while the federal government is <u>increasing the national deficit</u> to pay for its economic stimulus package, the state governments are <u>cutting spending</u> to balance budgets reduced by lower income and property taxes[1]. These actions are mutually offsetting, and the net effect is a delayed recovery for America.

Meanwhile, the US$1 trillion plan to buy up toxic assets from banks using taxpayer money has gotten off to a whimper, with just 9 fund managers and total funds of US$40 billion[2]. The managers are to raise US$10 billion, while the Treasury will invest US$10 billion and lend the funds US$20 billion. Despite the attractive terms, the small scale relative to both the initial announcement and the actual market (US$2 trillion) indicates that most investors think the underlying assets are poor. They are sensibly demanding realistic (read: steep) discounts when bidding, but the banks have balked at realizing huge losses, preferring to keep the paper in the hope that a rapid recovery will prove the assets good.

So far, the banks have been wrong. Loan delinquency rates are high, not just in the sub-prime segment, but also among prime borrowers, simply because so many people have lost their jobs. Since the recession began, 6.5 million American jobs have been lost, wiping out all the jobs created in the previous nine years. Needless to say, the jobless do not excel at paying mortgages on time – or at all. One in eight Americans is now either late on a home-loan payment, or already in foreclosure.

Japanese exports slumped again in May on a month-on-month basis after climbing in February through April. Against last year, May's exports fell 40.9%. In what passes these days for good news, the Bank of Japan reported on July 6 that "the pace of economic deterioration was slower in all regions."

In Germany, the Munich-based Ifo institute's business climate index rose for the second

[1] *Property Tax Appeals Take Rising Toll on Governments*, **The New York Times**, 4 July 2009.

[2] *U.S. Government Taps 9 Managers for Toxic Debt Program*, **Bloomberg News**, 8 July 2009.

straight month in May, but exports still fared poorly: May's manufacturing orders were up 4.4% from April, but still 29.4% lower than the previous year.

The much talked-about "green shoots" are making at best irregular appearances. As expected, China and India are proving to be the most resilient. Chinese manufacturing capacity[3] has picked up and hit a 10-month high in May. In the second quarter, China's economy actually grew at a 7.9% annualized rate against the previous year. In India, the Index of Industrial Production began climbing again on a year-on-year basis in April. Australia, a major provider of coal and iron ore to China, has again been the "lucky country" to ride China's resurgence; by most accounts it has already exited recession. Elsewhere, there are few signs of a recovery.

Confounding expectations, despite the poor economy, stock markets have staged a furious rally. Many major indexes have climbed 50% or more from their March lows, and now show gains on a year-to-date basis.

Some of the rally can be traced to depressed pricing. Many companies traded at prices implying imminent bankruptcy, or at least a dismal future, when in fact at least some were likely to survive and prosper in the recovery. Eventually, with enough people realizing this, fear of losses turned into hope of profits, and large-scale buying began.

The other part of the rally can be linked to global liquidity and currency depreciation. With serious money-printing going on in the US as part of the bailout package, the purchasing power of the US dollar is being reduced. However, other countries are keen to weaken their own currencies against the US dollar in order to boost exports.

Furthermore, almost every major country has lowered interest rates to boost liquidity and consumption, even though it was a borrowing binge that led to the current problems. As of mid-July, the respective overnight lending rates in key OECD economies were: USA 0.25%, Europe 1.75%, UK 0.5%, Japan 0.1%. At the common-sense level, it seems naïve to believe that more borrowing will fix problems caused by excessive borrowing, yet no central banker today appears to have a better idea.

All these weak-currency and cheap-money policies imply simultaneous – and global – inflation. In inflationary times, the *de facto* action is to invest cash into assets such as stocks, property, gold and commodities. Thus, global funds have rushed to put money back into the very assets they abandoned just six months ago. Fear of loss has turned into fear of being left behind, with massive purchases in blue chip stocks everywhere. The large amount of liquidity created in the prosperity of the past few years has only served to amplify the swings in fund flows.

Today, the global economy is in worse shape, yet stock prices are significantly higher. Investment gains that should have come over 2-3 unhappy years arrived in just 2 manic months. The investor's job has become harder. Fortunately, gems remain to be found by the diligent miner. Your manager has uncovered some, which will be described later.

Capital markets are likely to be volatile for the rest of the year, in a tug-of-war between pessimists who point out how bad the economy is, and optimists who counter that the recovery draws ever nearer. Your manager remains pessimistic about the world economy. In any case, investment activity will continue to focus on companies with good businesses, a bright future, and an attractive price tag. Your manager will write again when the report for the quarter ended 30 September 2009 is ready.

Benjamin Koh
Investment Manager
Lighthouse Advisors
23 July 2009

[3] As measured by the **CLSA China Purchasing Managers' Index**.

3. Portfolio Review

As at 30 June 2009, the Reference Account Net Asset Value (NAV) was $131.19 per unit, net of all fees. Highwater mark was $101.02, and total return to date for 2009 was 29.9%.

Twelve securities made up 83% of the Reference Account, with the balance in cash. A pie chart is in Annex I, while NAV values are tabled in Annex II.

New Investments

Hongkong Land is a major landlord in Hong Kong. It is part of the Jardine Matheson group of companies, which date back to 1832. Hongkong Land owns 13 large "Grade A" buildings in Central, the financial, business and government district of Hong Kong. These buildings form a substantial proportion of the prime office space in Central. Minor assets include residential developments in Hong Kong and Singapore, mostly held by 77%-owned MCL Land, which is listed in Singapore.

The balance sheet is strong; debt to equity is 33%, but cash on hand exceeds short-term debt, and long-term debt comprises a mix of bonds with varying maturities. Also, the deferred taxes liabilities, which count against asset revaluation gains, will not materialize as Hong Kong does not impose capital gains taxes. This increases shareholders' equity by about US$2bn, or almost US$1 per share. At purchase, the price was about 60% of revalued net asset value, and dividend yield was 5%.

Suntec REIT is a real estate investment trust with 4 properties in Singapore: the Suntec City office and retail complex, the One Raffles Quay office building, heritage retail development Chijmes, and furniture-focused Park Mall. The flagship asset is Suntec City; originally developed by Hong Kong tycoon Li Ka-shing's Cheung Kong (Holdings), it is the major shopping destination in its immediate vicinity, and also accounts for most of the prime office space in its neighbourhood.

Rents are currently being revised upward, as most tenancies were signed at comparatively low rates in 2006. From 2010 onwards, rents may see downward reversions from the high rates signed in 2007-2008. However, in 2010 the Circle Line subway line will also begin serving Suntec City. This will drive foot traffic higher, and should offset the downward pressure on rents from the poor economy. Debt to equity is 55%, but all the debt has been refinanced and is not due until 2011. At purchase, the price was below half of book value, and dividend yield exceeded 12%.

Esprit Holdings is an apparel retailer and distributor. It owns the *Esprit* and *edc* lifestyle brands, and the *Red Earth* brand of cosmetics. These are sold both wholesale to partners and directly via retail. Esprit operates worldwide, but its largest market is Europe (87% of sales), specifically Germany (47% of sales). Esprit has been a long-term shareholder's dream: since IPO in 1993, book value per share has multiplied 19 times. From 1994 through 2008, this represents a 14-year compounded annual growth rate of over 23% per year. This track record would be enviable even in emerging markets like China or India. But in Germany, a mature market, it is amazing.

The company has also consistently generated and paid out cash. In the last 10 years, profits converted into free cash flow at an average rate of 82%, and the dividend payout ratio averaged 58%. In the last 5 years, the average conversion rate was 96%, and payout ratio averaged 75%. Finally, the balance sheet is rock-solid. There is no debt, and the only significant intangible asset dates to 2002, when the company (then called Esprit Asia) acquired Esprit US to get worldwide ownership of the Esprit brand. The stock was bought at an estimated 12 times FY09 earnings, at a forward dividend yield of 6%.

4. Trade Receivables

Trade Receivables is an accounting term that refers to money owed to the company by its customers. Generally, businesses that deal with other businesses ("B2B") operate on credit, meaning that goods and services are delivered first, and payment is made later. Businesses that deal with consumers ("B2C") usually operate on a cash basis: payment is made immediately upon receiving the goods and services, or sometimes even in advance.

Clearly, a business that operates on a cash basis faces almost no risk of bad debts – if the customer can't pay, the goods and services are not provided. Restaurants are examples of cash businesses – no money, no food. This seems ideal, except that receiving cash means cashiers can and do steal money from the till. So it's not perfect - the savings in bad debt losses are offset by higher surveillance costs. The restaurant owner who saves money by omitting the closed-circuit television cameras will lose far more money to thieving cashiers.

Businesses that operate on credit have to manage credit risk. Too stringent, and customers go elsewhere, too lax and bad debts will be overwhelming. What are sensible payment terms? For B2C, the consumers usually get 30 days' credit – your utilities company, mobile phone provider, cable television service and credit card issuer all typically give you about 30 days to pay up. Therefore, companies in these industries should have trade receivables equal to or less than 30 days of sales.

For B2B, payment terms are usually 60 or 90 days, so trade receivables should represent between 60 and 90 days of sales. Much more, and there are probably bad debts that have yet to be recognized.

Some industries have very long sales cycles e.g. jewellery can take up to one year to sell, so the stores often have 365 days to make payment to their suppliers. Some companies also deal with customers who are much larger e.g. small suppliers selling to government departments. In such cases, government bureaucracy can result in payment only after 180 days or more, even if the bill was due in 90 days. Jewellery suppliers and government contractors are thus often strapped for working capital; their own suppliers and employees must be paid on time, even as their customers pay them at a leisurely pace.

These exceptional cases aside, any company with trade receivables that consistently exceed 90 days' worth of sales should raise a red flag to the investor. Often, they hint of operating difficulties at the company and suggest that problems lie ahead.

Two recent examples where taking note of trade receivables would have saved investors from severe losses are described below.

Case 1: China Printing & Dyeing was a textile printing and dyeing company based in Zhejiang, China. It was one of the largest such companies in China. It listed on the SGX in 2006, and for a while, things went well. But the financial crisis that struck in 2008 proved to be a breaking point. In October 2008, deep in debt, with exports floundering, founder Tao Shoulong decided to simply walk away.

Tao burned the financial books, sold his club memberships and his Mercedes sedan, and fled with his wife Yan Qi, who was also the general manager of the company[4]. Several days later, the independent directors belatedly announced that Tao and his wife were not contactable. Soon afterwards, the company was placed under judicial management and the shares were suspended from trading. Given the weak balance sheet, it seems unlikely that shareholders will receive anything after creditors are paid. In other words, shareholders will probably be wiped out.

What were the warning signs?

An alert investor would have noticed 2 things: a heavy debt load, and a large amount of trade receivables. Sales and profits were growing, but so were debts and receivables. The company used both bank debt and corporate IOUs to finance its operations; total debt

[4] *China's bosses are abandoning ship*, **Los Angeles Times**, 3 November 2008

consistently made up 50% or more of corporate assets, and formed 150-300% of shareholders' equity. A small misstep would mean disaster. Yet the company was being paid slowly: trade receivables were consistently over 100 days of sales, and were actually 210 days of sales at one point.

As previously noted, trade receivables are normally between 60 and 90 days' worth of sales. Textiles don't have a very long sales cycle, so there is no reason for customers to pay late. So in this case it was a clear warning that many of the reported sales and corresponding profits were artificial, because the money hadn't actually been collected, and might never be collected.

Case 2: Beauty China was a Chinese cosmetics distribution company. Its *Colour Zone* brand held a 4% share of China's cosmetics market, after *Maybelline New York*, *Artistry* and *L'Oreal Paris*. From 2000 to 2007, revenue rose from HK$67m to HK$633m, a compounded annual growth rate of 38%. However, in early 2009 the company dropped a bombshell: it would have to write off a significant proportion of its trade receivables. Worse was to come: the company had taken out a loan to buy a factory, and the lender demanded immediate repayment, which the company was unable to do because of slow collection of trade receivables. The shares are currently suspended.

Were there hints that trouble was brewing?

Tracking the company quarter by quarter, it would have become evident that trade receivables were creeping up from 70-80 days of sales to 90 days of sales. The company also admitted in recent announcements that it was relaxing credit terms to help its distributors who were hit by the financial crisis.

Although the company was selling to distributors, these distributors in turn sold to retailers, who sold the cosmetics on cash terms. Therefore, the sales cycle was relatively short, and the increase in trade receivables would have raised a red flag. 90 days of sales in trade receivables means that half the customers are paying in less than 90 days, and half are paying after 90 days. Such a long period of payment implied that some goods weren't actually being sold; they were simply piling up in the distributors' warehouses. Eventually the distributors were unable to store more goods, and the game was up.

Also, the company left some important clues in its presentation slides to investors: it quoted data provider *Euromonitor International* on China's total colour cosmetics sales and Beauty China's market share. These statistics made it possible to calculate the retail value of Beauty China's sales.

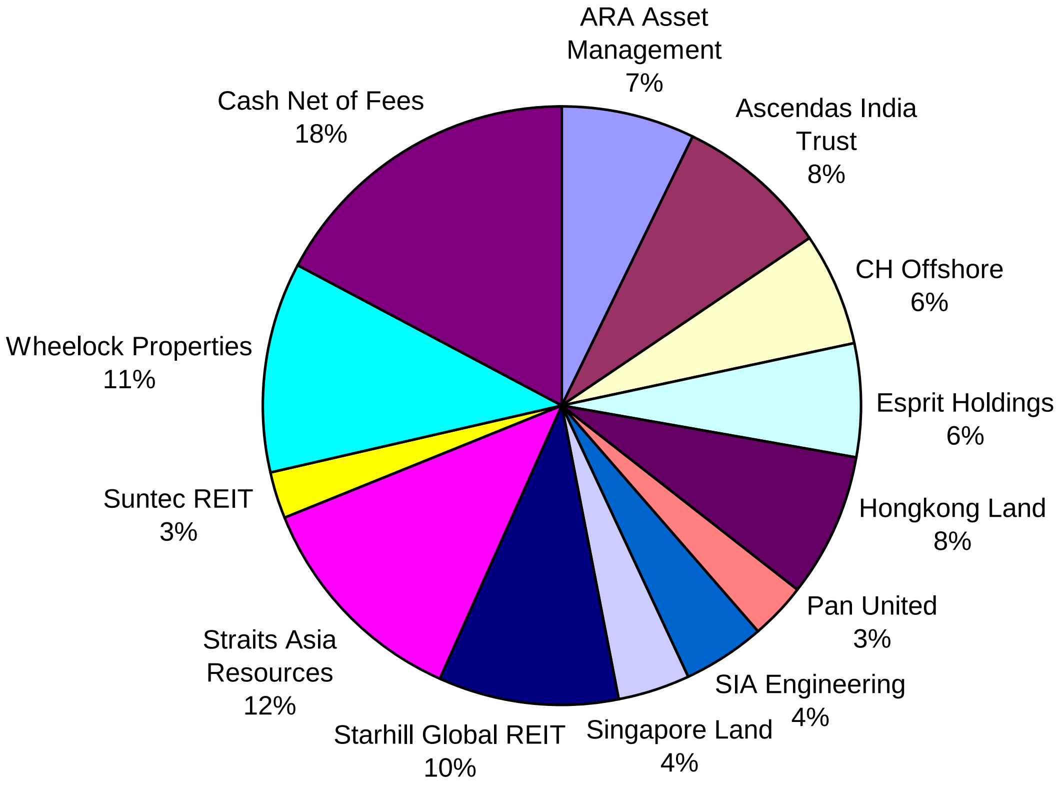
In 2007, total colour cosmetics sales in China were RMB 11bn. With Beauty China's 4% market share, the implied retail value of its sales would be RMB 440m. Beauty China sold its products at a 40% discount to the retail price, so sales to distributors should have been RMB 264m. But Beauty China's reported sales for 2007 were HKD 633m. In 2007, RMB and HKD were about even, so that meant Beauty China's sales were more than twice what the *Euromonitor* data implied. Taken together with the high level of trade receivables, the logical conclusion was that Beauty China was simply transferring excess goods to distributors and booking these transfers as sales, while the actual retail sales, as reflected in the *Euromonitor* numbers, were much lower.

Final Note: your manager is able to describe these companies in such detail because he used to be personally invested in these companies. Fortunately, he escaped in time, precisely because of the warning signs described. He is wiser today, and has no intention of repeating these harrowing experiences.

End

Annex I

Reference Account as of 30 June 2009



Annex II

Monthly NAV Values

Date	Net Asset Value per Unit	% Invested
30 Nov 2008	$100.00	16.2%
31 Dec 2008	$101.02	52.7%
31 Jan 2009	$103.03	52.7%
28 Feb 2009	$102.42	69.4%
31 Mar 2009	$100.11	51.4%
30 Apr 2009	$106.95	68.2%
31 May 2009	$131.41	77.2%
30 Jun 2009	$131.19	83.1%