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Keeping Your Capital Safe

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Client Newsletter for the period ended 30 Sep 2009

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1. Foreword

Fellow Investors,

Welcome to the Lighthouse Advisors newsletter for September 2009. This marks the fourth quarter of operations.

This newsletter follows the same format as previous issues. The special topic for this issue is **Related Party Transactions**.

2. Market Commentary

After four consecutive quarters of decline, America has officially exited recession[1], growing at a 3.5% annual rate in the three months ended September 2009. Still, the general near-term outlook has not improved. China continues to grow, albeit at a slower pace, but its key export markets in the West remain in the doldrums. Those economists who predicted a robust global recovery in the second half of 2009 do not seem so smug now.

After a brief dip to 9.4% in July, US unemployment rebounded to reach 9.8% in September, again the worst level since August 1983. Worryingly, a US Federal Reserve official has publicly conceded[2] that the "real" unemployment rate, which includes those people who have given up looking for work or who are under-employed, is actually **16%**. Furthermore, he expects a "protracted period of high unemployment." To call this admission sobering would be a definite understatement. The *New York Times* also recently noted that companies are increasingly implementing pay cuts for existing workers on top of layoffs[3].

US government debt continues to rise; the 2009 budget deficit is now estimated[4] at US$ 1.6 trillion, about 11.2% of GDP. Total government debt held by the public is expected to reach 54% of GDP this year. This seems acceptable compared with Japan's government debt-to-GDP of 170%, but Japan is in fact a net creditor nation – its overseas assets exceed its overseas liabilities. In other words, its debts are an internal problem and mutually offsetting.

In contrast, America is a net debtor nation, and owes the rest of the world, especially China, big time. While nobody today can force America to pay up, basic common sense dictates that a weak national balance sheet erodes influence in international affairs, especially in economics and politics.

The US dollar is no longer the reserve currency of choice. It is probable that the Euro and Yen, and eventually the Rupee and Renminbi, will feature prominently in future central banks' foreign reserves. Iran already keeps more Euros than US dollars in its foreign reserves, and a top Chinese official has stated[5] that China will "diversify incremental foreign reserves into euros, yen and other currencies."

The increased presence of non-US currencies in central bank foreign reserves can be

[1] *GDP Grows By 3.5%*, **Forbes**, 29 October 2009

[2] *The US Economy and the Employment Challenge*, **Dennis Lockhart, President & CEO, Federal Reserve Bank of Atlanta**, 26 August 2009

[3] *Still on the Job, but at Half the Pay*, **The New York Times**, 13 October 2009

[4] *The Budget and Economic Outlook: An Update*, **Congressional Budget Office**, August 2009

[5] *China alarmed by US money printing*, **Telegraph.co.uk**, 6 September 2009

expected to parallel the rise of the respective issuing nations. We may even see the return of **gold**, as central bankers eventually realize the futility of holding fiat money created at the whim of others. Incidentally, China now holds over 1,000 tons of gold reserves, which put it ahead of Switzerland, and rank it 5th in the world[6].

Toxic financial assets remain on bank balance sheets. The International Monetary Fund recently reduced its estimate[7] for total writedowns by financial institutions in this crisis to "only" US$ 3.4 trillion. So far, US$ 1.3 trillion in losses has been officially recognized, and the IMF expects a further US$ 1.5 trillion of writedowns through the end of 2010. In other words, the worst is yet to be.

This year, banks have been raising funds to shore up their balance sheets. However, the amount raised so far in 2009, by all corporations, is about US$ 1.5 trillion in toto. If we assume financial institutions accounted for all of this money, it would cover past sins, but would not suffice for future penance. There is more pain to come.

Meanwhile, in the physical housing market, the default contagion continues to spread. Now, it has afflicted borrowers who *can* afford to pay their mortgage. In ten US states, housing loans are non-recourse: if the loan goes bad, the bank can only seize the house and not the borrower's other assets.

Not surprisingly, an increasing number of people with pristine credit histories are choosing to walk away from homes where they have negative equity i.e. the house value is less than that of the outstanding loan. In this way, at the cost of ruined credit for a few years, they save themselves hundreds of thousands of dollars, and can start again elsewhere. They may even buy *another* house at today's depressed prices.

[6] *China's gold reserves reach 1,054 tonnes*, **China Daily**, 24 Apr 2009

[7] *Global Financial Stability Report*, **International Monetary Fund**, 30 September 2009

Who suffers when borrowers walk? The banks, and their shareholders? In theory, yes. In practice, it has been the American taxpayer, as one mega-bank after another has been saved with government largesse. Clearly, something is fundamentally wrong with the US model of capitalism when profits are privatized, and losses are socialized. Yet, the banking reform debate today is not about changing the way banks operate and pay people, but merely about capping the quantum of pay. An earlier attempt to limit bonuses merely caused base salaries to inflate; it would seem naïve to expect that any new restrictions will be more effective at reducing reckless risk-taking.

The *New York Times* has pointed out this "too big to fail" problem[8] but notes that the proposed controls do not go very far. Even Alan Greenspan, the former Federal Reserve chairman now widely blamed for the housing boom and the subsequent crisis, recently called for the giants to be broken up, saying that "failure is an integral part, a necessary part of a market system."[9] Unfortunately, so far, the regulators have shown little interest in shrinking the mega-banks down to a manageable size.

The US is not alone in its misery: elsewhere, for those who are neither Chinese nor Indian, the picture continues to be grim.

Japanese exports remain weak. August was the 11th consecutive month of decline, and against last year the fall was 36%. Unsurprisingly, car exports dropped 50%. Toyota and Honda may be faring better than GM, Chrysler and Ford, but they are still doing badly in absolute terms.

In Germany, July's manufacturing orders were up 7% from June, but still 22.3% lower than the previous year. Today's uncertain world economy still sees little need for high-quality, high-priced German goods, whether they are produced by Siemens or Volkswagen.

[8] *If It's Too Big to Fail, Is It Too Big to Exist?* **The New York Times**, 20 June 2009

[9] *Greenspan Says U.S. Should Consider Breaking Up Large Banks*, **Bloomberg News**, 15 October 2009

In Spain, one of Europe's worst-hit economies, banks have taken over € 20 billion of houses from failed developers in an attempt to prop up prices[10], and are trying to re-ignite the housing boom with 100% mortgages, low interest rates, and even free cars. No surprise that with unemployment currently at 18.5%, these measures are having limited success.

Ironically, with banks now competing with developers to sell real estate, the banks' willingness to offer cheap financing will probably put more developers out of business – and force the banks to take over yet more houses that they have to sell later.

Even in India, which the IMF projects will grow 5.4% in 2009, there is hardship linked to the financial crisis in the West: plunging US retail sales of diamond jewellery – an expected outcome of the crisis – have devastated Surat[11], home to half of India's 710,000 diamond workers. India cuts and polishes 11 out of every 12 diamonds sold in the world, so the pain was quickly felt when Lehman Brothers collapsed last September and sent shock waves through the global economy.

Likewise, even as middle-class Chinese splurge on clothes and food, China's exports have foundered, declining 23.4% in August versus the previous year. 20 million migrants have returned to the countryside; they will not be coming back to the cities so soon.

Finally, rebutting claims that the recovery has arrived, the "ghost fleet" anchored off Singapore[12] bears mute testimony to the precipitous decline in international trade.

As for the stock markets, prices have begun to stabilize as bargains have been snapped up, while overvalued companies have been sold down to more realistic levels. Prices remain volatile, but now they no longer stray too far from sensible levels.

It will be a while before market euphoria and the accompanying bubble valuations return. In the meantime, in a sea of "fair" prices, your manager searches for great businesses in which money can be safely invested for the long term. In the absence of outright bargains, this remains the preferred strategy. Your manager will write again when the report for the quarter ended 31 December 2009 is ready.

Benjamin Koh
Investment Manager
Lighthouse Advisors
29 October 2009

3. Portfolio Review

As at 30 September 2009, the Reference Account Net Asset Value (NAV) was $145.88 per unit, net of all fees. The highwater mark was $101.02, and the total return to date for 2009 was 44.4%.

16 securities made up 95% 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

Asia Financial Group is a Hong Kong-based general insurer. It also owns stakes in other financial companies, including PICC (HK) and PICC Life, two insurance ventures with the People's Insurance Company of China. It also holds a 19.5% stake in Bumungrad International, the international arm of Bumungrad Hospital, one of Thailand's top hospitals. Both PICC Life and Bumungrad International are growing steadily, and should eventually become significant contributors to Group profits.

The core underwriting business has been consistently profitable. For the last 7 years up

[10] *Pain in Spain May Linger as Banks Seek to Avoid Property Losses*, **Bloomberg News**, 2 October 2009

[11] *Diamonds Post-Lehman Have No Aura as Buffett Can't See Recovery*, **Bloomberg News**, 15 September 2009

[12] *Revealed: The ghost fleet of the recession*, **Mail Online**, 14 September 2009

to the end of 2008, underwriting profits compounded at the rate of 21% per year. Nonetheless, Group profitability is dominated by investment returns. Last year, like many financial companies, the Group reported significant mark-to-market losses. However, the balance sheet withstood the hit, and some of the losses have since been recouped in the market recovery this year. Absent a complete breakdown of common sense, the future investment profits should be quite satisfactory.

The balance sheet consists mainly of cash and investments. There is no debt, and cash alone exceeds all liabilities. The stock was bought at about 55% of book value. The Group also pays a dividend; the forward yield is 4%.

China Construction Bank (CCB) is one of the "Big Four" state-owned banks in China. It ranks second by assets after ICBC, and today it has over 13,000 branches and sub-branches nationwide, with over 31,000 ATMs and more than 3,000 self-service banks.

As an agent of the government, the bank's short-term future is dictated by the central bank. Changes in lending standards, reserve ratios and other top-down edicts will induce short-term fluctuations in both the quality and quantity of the bank's loan book, and its subsequent profitability.

In the medium and long term, the bank is a bet on the Chinese economy. Apart from industry, which will use more credit as it grows, the Chinese consumer will use more financial products in future. The Chinese remain huge savers due to the poor quality of public services such as healthcare, education, and aged care. As China develops in these areas, the need to salt away huge proportions of income will fade, and consumption will rise, fueled by loans and credit cards.

There will also be more appetite for insurance products to help pay mortgages, bring up children, and pay for medical treatment. And of course, the hunger to get rich quicker will drive demand for asset management services.

In such a growing market for financial services, the distribution network is key. First-mover advantage is critical. Fortunately, the bank is already well-entrenched, with a strong brand name and a ubiquitous presence nationwide. CCB and its bigger sibling ICBC are likely to remain as major players for the foreseeable future, and should a "winner takes all" situation emerge, CCB and ICBC are the most likely ones to remain standing after the consolidation is over.

The balance sheet is good, with debt to equity at 19%. At purchase, the price paid was 2.5 times book value, and about 12 times earnings. Dividend yield was 4%.

Hsu Fu Chi is a leading Chinese manufacturer of New Year candies. From 1998 through 2007, it was ranked #1 by sales in its category by the National Bureau of Statistics. Since IPO in 2006, sales have compounded at 22% per year, while profits rose at a 28% rate. For the year ended 30 June 2009, profits grew 29%. The company also increased the dividend 93%, a clear vote of confidence by management in the strength of the business.

The balance sheet is sound, with debt to equity of just 1%. Due to seasonal sales patterns, the company has historically taken on seasonal debt; this debt will decline in future as cash builds up in the balance sheet. At purchase, the price was about 11 times forward earnings, and expected dividend yield was 4%.

Luk Fook is a Hong Kong-based jewellery retailer and distributor. It operates 31 stores in Hong Kong and 19 stores in mainland China. In addition, there are 400 licensee stores in mainland China. More than half the sales in Hong Kong come from Chinese tourists. As Chinese tourist arrivals in Hong Kong increase, their relative importance in sales will continue to rise. For the ethnic Chinese, gold appeals as both a store of value and a marker of prosperity; as China develops, gold purchases are likely to rise in tandem, and Luk Fook will benefit accordingly.

The company has a good record of generating and paying out cash. In the last 9 years, reported profits converted into free cash flow at an average rate of 81%, and the dividend payout ratio averaged 46%. During the same period, sales grew at 9% per year, while profits rose at 15% per year. Return on equity averaged 17% throughout the period.

The balance sheet is strong, with debt at 13% of equity. Debt will rise with the recent purchase of a building for both headquarters and show room use. However, as the Group will then return some of its existing leases, the net impact on cash flow should be minimal. The stock was bought at 6 times forward earnings, at a yield of 4%.

Sa Sa International is a multi-label cosmetics retailer and distributor. Starting with a single 40 square-foot counter in 1978, founders Eleanor and Simon Kwok have built Sa Sa into the largest cosmetics retail chain in Hong Kong. Sa Sa went public in 1997 and continues to deliver shareholder value. Even in difficult years, when the group made losses, dividends were paid.

From 2000 through 2009, the dividends paid averaged 98% of net profits. During this period, despite retaining virtually no profits for reinvestment and issuing almost no new shares, sales grew 12% annually, while earnings per share increased at 17% per year. Attaining the growth by itself would already be a good result, but to do so while paying out practically all the earnings is an outstanding achievement by management.

The balance sheet is excellent: no debt, and cash at more than twice total liabilities. The stock was bought at about 14 times forward earnings, at a dividend yield of 7%.

4. Related Party Transactions

Related Party Transactions, also known as "Connected Transactions" or "Interested Party Transactions", are <u>insider</u> transactions. While most such transactions are too small to have a material impact, some are of sufficient scale to merit detailed attention. Two examples of the latter are detailed below.

Case 1: Kingboard Copper Foil (KCF) is a manufacturer of copper foil. Its products are used in the printed circuit boards that underpin substantially all of today's electronic goods. KCF is a 64% subsidiary of Kingboard Laminates. Other companies in the stable include Kingboard Chemical (the parent of Kingboard Laminates) and Elec & Eltek, also owned by Kingboard Chemical.

For FY08, KCF derived **87%** (FY07: 91%) of its total revenues from other members of the Kingboard group. In other words, it is effectively a <u>captive manufacturer</u> with little or no real ability to charge market prices.

Of course, there do exist regulations on such connected transactions, and for KCF, these dealings are required to be on terms "no more favourable" than those offered to external parties.

But given that so much of the sales are to related parties, one should question whether minority shareholders are truly getting a fair deal. While it may be *legally* true that all customers are eligible for the same prices on the same terms, nothing says that the outside customers are able to meet those terms e.g. the minimum order quantity could be huge, the specifications may differ etc.

With the 9:1 proportion of connected versus external sales, it is also possible, and even probable, that there are products that are sold only to Kingboard group members, and for which no external reference price thus exists. As such, the *practical* result may be that the parent can enjoy favorable pricing that outside customers are unable to obtain i.e. the company's profit margins are below what they should be if it sold only to external parties.

Since KCF has no significant external business, should it be privatized? Kingboard Laminates has in fact made a recent offer to privatize KCF. The offer was rejected by

independent shareholders who felt the offer price was too low. But they have forgotten that as the major customer and majority owner, Kingboard Laminates is the only possible buyer for KCF.

The low price offered by Kingboard Laminates fully reflects the fact that there is no competing buyer. A sensible investor should simply avoid KCF rather than raise a hue and cry, for Kingboard Laminates is simply doing the right thing for its *own* shareholders i.e. buy useful assets cheaply.

Case 2: Chaoda Modern is a supplier of fruits and vegetables in China. It provided over 50% of the vegetables used in the core venues of the 2008 Beijing Olympics. Chaoda currently operates 34 production bases across 15 regions in China.

As a farming concern, a key input for Chaoda is fertilizer. It purchases organic fertilizer from a 95% subsidiary of a trading company, which is in turn 95% owned by Mr Kwok Ho, the chairman and controlling shareholder of Chaoda. In FY2008 these purchases amounted to RMB 530 million, or 34% of Chaoda's total cost of goods sold. Clearly, there is a direct relationship between the cost of fertilizer and the company's profitability.

The transactions were conducted pursuant to a supply agreement signed in 2006 and approved by independent shareholders. They specify that the price paid by Chaoda will not exceed the average ex-factory price given to external parties. In other words, Chaoda is getting a fair-or-better deal. This would seem to be a good thing for the company, and by extension its shareholders.

But if the company is deriving benefits from favourable fertilizer prices, the investor must then consider *why* the company's profits might be inflated by artificial subsidies from Mr Kwok. One possible answer may be found in his share sales over the years.

Higher corporate profits usually result in a higher share price, which can yield additional sales proceeds that more than offset any profits foregone in subsidizing the company. As it happens, from 2003 through 2008, Mr Kwok progressively reduced his holdings in the company, from 986 million shares down to 643 million shares. Taking into account new shares issued to investors as well as exercised options, his stake fell dramatically from 51.5% in June 2003, to just 25.4% in December 2008.

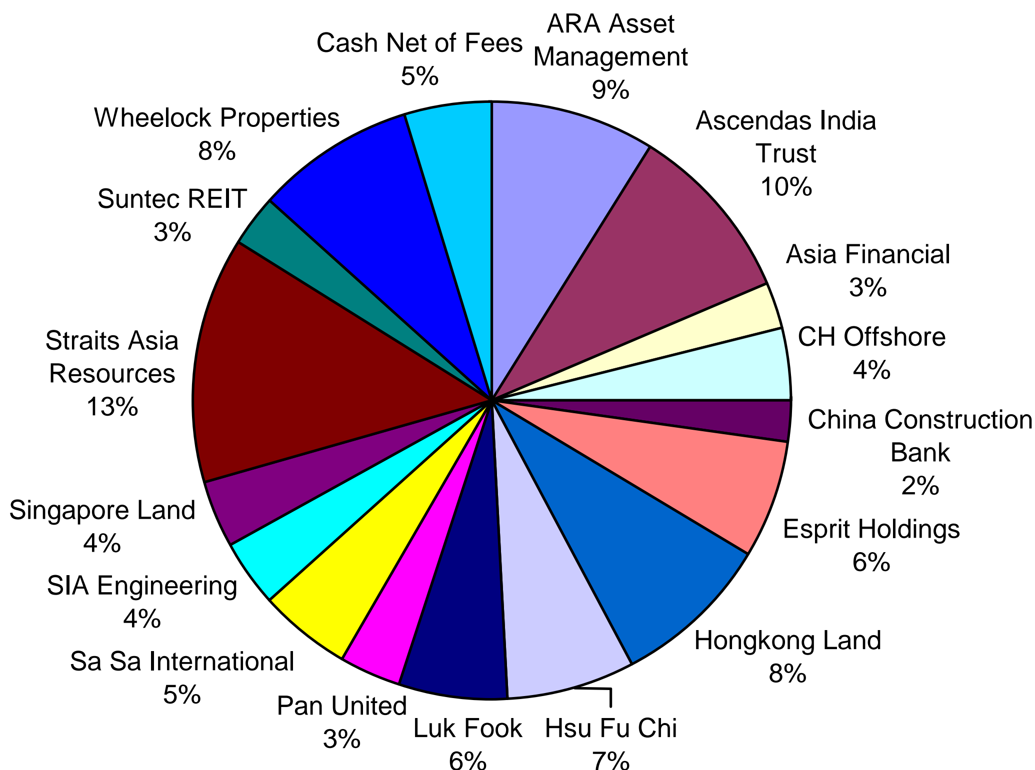
For as long as Mr Kwok continues to sell his shares, there will be an overhang in the market which depresses the stock price. This would be fine for long-term shareholders if the share sales eventually stopped. But if the share sales stopped, so might the supply of cheap fertilizer, and thus the company's good profits.

Lower profits would then imply a lower valuation for the company. It looks like a no-win situation. Ultimately, investors should question the wisdom of buying into a company whose owner is so keen to reduce his stake.

End

Annex I

Reference Account as of 30 September 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%
31 Jul 2009	$141.98	85.7%
31 Aug 2009	$140.77	92.2%
30 Sep 2009	$145.88	95.2%