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Keeping Your Capital Safe

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Client Newsletter for the period ended 31 March 2010

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1. Foreword

Fellow Investors,

Welcome to the Lighthouse Advisors newsletter for March 2010. This marks the start of the second full year of operations.

This newsletter follows the same format as previous issues. The special topic for this issue is **Accounting versus Reality**.

2. Market Commentary

So far, the year of the Tiger notwithstanding, stock markets have not exactly gotten off to a roaring start in 2010. Your manager considers this to be healthy, as the rapid rise in stock markets worldwide in 2009 was not matched by a meaningful economic recovery.

A pause or even a decline in 2010 will allow corporate earnings to catch up to expectations. It will also allow your manager to put money to work. In terms of stock market returns, the worse 2010 is, the better 2011 is likely to be. If the first few months of 2010 are anything to go by, your manager has high hopes for 2011.

The Great Recession seems to have passed, though the recovery remains weak overall and highly unbalanced. The US housing market is anemic, trading conditions are poor in Europe, and Japan is stuck in neutral gear. Meanwhile, China and India are on the verge of overheating. But perhaps this is indeed the "new normal" envisaged by those who point out that the last decade was an abnormal Goldilocks period, during which conditions were just right, so that everything fell into place, and everyone prospered.

America's housing market train wreck has been extensively discussed in the mainstream media; suffice to say that "bottomed out" is the most optimistic view that can be reasonably articulated for now given the data.

Farther north, Canada's housing market is causing fresh unease. Traditionally viewed as conservative, Canadian banks sailed unscathed through the crisis. This won them widespread acclaim, except it turns out the banks had offloaded their toxic debt to the Canadian Mortgage and Housing Corporation (CMHC), which works like America's Fannie Mae and Freddie Mac in guaranteeing home loans.

CMHC now guarantees loans where buyers put down a 5% deposit and take out a 35-year loan. These are terms consistent with speculative activity and sub-prime borrowers. The approval rate for loans to such high-risk borrowers was 42% as recently as 2008[1]. If the problems at Fannie Mae and Freddie Mac are anything to go by, Canada may be in for some unhappy times ahead.

Europe continues to produce bad news. Greece's financial woes were mentioned in the previous newsletter; it has now been joined by a few friends, and the group has been given the cute-sounding acronym of PIIGS: Portugal, Ireland, Italy, Greece and Spain.

The PIIGS countries are actors in a Greek tragedy with no happy ending[2]. They all have problems with their budgets, and have a large external debt relative to their GDP.

The EU rules only allow bailouts in natural disasters or circumstances beyond the member

[1] *Canada's Sub-prime Mortgage Time Bomb*, **The Monitor**, 1 December 2009

[2] *The Greek Tragedy That Changed Europe*, **Wall Street Journal**, 13 February 2010

country's control. Greece is not experiencing a natural disaster, and its circumstances were self-inflicted, albeit with some help from an investment bank named – you guessed it – Goldman Sachs[3].

It would be a mockery of the EU if it broke its own rules to suit itself. But if it helps Greece anyway, the other PIIGS members will line up for their share of aid, increasing the bill to the solvent EU members, principally Germany.

Yet, without EU aid, Greece could default, which would shred any remaining confidence in the Euro and hurt the other EU members. The other PIIGS would likely default in quick succession as well. This would further weaken the Euro, which would help exporters like Germany, but other EU members would see their borrowing costs rise. Some might be pushed to the margin and need help too, and Germany would be stuck with the bill again.

After months of debate, the Germans have reluctantly agreed to support a bailout of sorts: the EU will lend Greece €30bn *if needed*[4]. The IMF will also chip in €15bn to help. Both the EU and IMF loans will be at below-market rates, to help ease the burden on Greece.

The Germans of course hope that the mere proposal of the package will improve market sentiment enough to allow Greece to borrow all it needs… from someone else. Actually having to *lend* the money would be quite distasteful. Unfortunately, the latest news is that Greece has called their bluff and asked to activate the aid package[5].

In the end, though, it is basically a given that the PIIGS will all be bailed out, albeit after forcing through some painful reforms, like actually *collecting* taxes instead of allowing rampant tax evasion[6].

Refusing aid to the PIIGS could trigger a collapse of the Eurozone. Even France and Germany, despite being the likely survivors of an EU breakup, do not want such a mess on their hands. The integrity of the EU is sacrosanct, for it is Europe's only real way of retaining influence in a world dominated by the US-China relationship.

Goldman Sachs, by the way, is facing some trouble of its own. The Securities and Exchange Commission (SEC) recently filed suit, charging the investment bank with fraud[7]. Apparently, Goldman Sachs sold a synthetic collateralized debt obligation (CDO) to investors without telling them the mortgages used in the CDO had been specially selected by hedge fund manager John Paulson.

Paulson was betting *against* the CDO, so of course he chose the worst mortgages. The deal was done in early 2007. Within six months, 83% of the mortgages had been downgraded. By early 2008 the proportion was 99%.

The CDO investors lost over US$1bn. Their losses became Paulson's profits – his credit fund made US$1bn on the CDO, and gained 590% overall in 2007. Clearly, Paulson was very smart, and the CDO investors were… not as smart. But were they simply dumb, or were they actively misled by Goldman Sachs? That is something the SEC lawsuit aims to answer.

In the Middle East, Dubai is still in bad shape. State-owned Dubai World recently offered to pay its debtor banks with new loans paying just 1% in interest, against the current market rate of 5%. Unsurprisingly, the banks were not enthusiastic[8]. Sadly, financial markets have a

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[3] *Wall St. Helped to Mask Debt Fueling Europe's Crisis*, **The New York Times**, 13 February 2010

[4] *EU ministers agree Greek bailout terms*, **The Guardian**, 11 April 2010

[5] *Greece Requests EU-IMF Rescue in Euro's Biggest Test*, **Bloomberg News**, 23 April 2010

[6] *Greek taxpayers sense evasion crackdown*, **Financial Times**, 16 April 2010

[7] *S.E.C. Accuses Goldman of Fraud in Housing Deal*, **The New York Times**, 16 April 2010

[8] *Dubai Stocks Drop Most in 3 Weeks on Dubai World Interest Plan*, **Businessweek**, 18 April 2010

short memory, and when other Dubai entities look to borrow again in future, there will be new investors eager to lend, which will plant the seeds of a future debt shock.

In Japan, the reports of a recovery have been greatly exaggerated. Japanese icons Honda and Toyota have received black eyes for quality failures and been forced to recall defective vehicles. Their hard-earned reputations have been tarnished. Toyota, in particular, increasingly looks like the old General Motors: huge, successful, and arrogant. It was recently revealed that Toyota hired ex-regulators to deal with federal investigations involving cases of unwanted acceleration; at least 4 such investigations were ended with their help[9].

Toyota has recalled at least 8 million vehicles since last year. Its woes continue to pile up; the latest is a *Consumer Reports* "Don't Buy: Safety Risk" verdict on the Lexus GX 460, which has forced Toyota to temporarily halt production[10].

Australia remains the only developed country to report good news. It has raised interest rates yet again, after deciding that "the expansion in most of Australia's major trading partners in Asia was proceeding strongly[11]." In other words: China is buying lots of iron ore and coal from Australia, at higher-than-expected contract prices.

China was the strongest economy in 2009, growing an estimated 8.7%. But the stimulus injected *last* year is overheating the economy *this* year. In particular, a revival in the property markets has made housing in first-tier cities like Beijing and Shanghai increasingly unaffordable. China's National Bureau of Statistics reports that the average house prices in 70 major cities rose 11.7% year-on-year in March. Haikou and Sanya, both on Hainan Island, led the charts with price rises of over 50% in the last 12 months.

The looming property bubble has not escaped official attention. After the initial verbal warnings went unheeded, the government increased bank reserve ratio requirements to restrict lending, and raised interest rates to increase the cost of funds. These proved ineffective too, so an edict was issued to stop 78 state-owned enterprises from engaging in property development. There was still no response, so the latest measures now require a 50% cash deposit on second homes[12].

For 2010, the recovery looks uneven. The IMF's latest update[13] expects that advanced economies (read: US, Europe and Japan) will grow 2.1% in 2010, while the emerging and developing economies (almost everyone else) will grow 6.0%. China is expected to grow 10.0%, and India, 7.7%. These are heady figures indeed, and inflation will be a real challenge. Still, too much growth is a problem many countries would be happy to have.

In terms of stock market action, there remains the risk of money from the developed world flooding into Asia in search of returns. If this occurs, prices will be pushed up quickly, and we will soon witness the next stock market bubble – and the inevitable collapse afterward. Your manager remains watchful, and will write again when the report for the quarter ended 30 June 2010 is ready.

Benjamin Koh
Investment Manager
Lighthouse Advisors
24 April 2010

[9] *Regulators Hired by Toyota Helped Halt Acceleration Probes*, **Bloomberg News**, 13 February 2010

[10] *Toyota temporarily halts production of Lexus GX 460*, **Tire Business**, 19 April 2010

[11] *Minutes of the Monetary Policy Meeting of the Reserve Bank Board*, **Reserve Bank of Australia**, 6 April 2010.

[12] *China's real estate time bomb ticking*, **China Daily**, 19 April 2010

[13] *World Economic Outlook Update*, **International Monetary Fund**, January 2010

3. Portfolio Review

As at 31 March 2010, the Reference Account Net Asset Value (NAV) was $179.88 per unit, net of all fees. The highwater mark was $166.03, and the total return to date for 2010, net of all fees, was 8.3%.

15 securities made up 94.9% of the Reference Account, with the balance in cash. A pie chart is in Annex I, while NAV values are tabled in Annex II. The size of holdings have changed somewhat as your manager recently deposited cash into the account and added to some existing holdings.

Divestments

Hongkong Land was divested due to significant price appreciation. This eroded the margin of safety, so your manager decided to sell. Total profits recorded exceeded 90%.

Singapore Land was also sold due to price appreciation. The reduced margin of safety prompted the decision to exit. Divestment gains were over 90%.

New Investments

Goodpack is a logistics company specializing in Intermediate Bulk Containers (IBCs). Goodpack's patented IBCs fold flat and stack for easy transport, and 16 filled IBCs fit into a standard shipping container. Because IBCs last for years and use space more efficiently than barrels or pallets, they offer significant cost savings when transporting cargoes.

Goodpack is the largest IBC operator in the world, with a fleet size of over 2 million. This makes it about 50 times the size of its closest competitor and gives it a huge advantage in matching supply and demand.

Goodpack started with natural rubber, and today its IBCs transport over 40% of the world's natural rubber. Other goods moved by its IBCs include synthetic rubber, edible oils and fats, fruit juices, and even automotive parts. To date, Goodpack has never lost a customer, even as trade flows have ebbed with the economic tides.

Previously, Goodpack focused on expanding the IBC fleet. This consumed the cash generated from operations and necessitated significant borrowings. It also depressed IBC utilization rates, which translated into excess capacity when the downturn hit. Fortunately, this served as a wakeup call to management, and capital expenditure has slowed. New IBCs are now leased instead of purchased outright. As a result, free cash flow has improved, and borrowings are being paid down.

Despite past inefficiency, the company has generated impressive returns: return on equity averaged 20% over the past 6 years, while return on assets averaged 14%. Sales and profits both grew at a compounded rate of 21% per year.

FY2009 was the worst year, when the company earned 15% on equity and 8% on assets. Still, such results would be very credible for most companies in a normal year, let alone an awful year. Sales still rose, albeit by only 3%, while profits fell about 12%. These results underscore the fundamental strength of the company's business: its services are too useful to be abandoned. One key customer, **Goodyear**, has even converted entire factories to use Goodpack's IBCs exclusively. Your manager expects returns to improve, and growth to resume, once the global economy recovers.

At investment, the company's shares traded at about 15 times the trailing 12 months' earnings, and about 2 times book value. Debt to equity was about 0.59, but the book value is depressed as the IBC fleet is carried at about half its true replacement cost. Dividend yield was about 2%, low but unsurprising given the high capital expenditure combined with the relatively high price/earnings ratio.

Your manager bought the 30 November 2012 warrants instead, as the warrants offered a rare combination of long life (almost 3 years), meaningful gearing (about 2 times) and low

premium (zero!). Given the low dividend yield and zero premium, the opportunity cost to purchase the warrants instead of the underlying shares was very low, and the gearing actually reduced risk by limiting the maximum loss should things go sour. These factors combined to make the warrants a superior investment to the underlying shares.

Kingboard Laminates is the world's largest producer of copper clad laminates. The laminates are used in printed circuit board production and are thus vital components in electronics manufacturing. It also produces upstream component materials such as bleached kraft paper, epoxy resin, glass yarn and glass fibre. It produces copper foil via its 64% subsidiary **Kingboard Copper Foil** (discussed in the 30 Sep 09 newsletter).

The Group dominates paper laminates with a 40% worldwide market share, and a 50% market share in China. For glass epoxy laminates the figures are 10% and 20% respectively. In the overall laminates market, the latest data show the Group has a 14% market share; the main competitor is Nanya Plastics with a 13% share. The rest of the market is fragmented and taken up by niche players in developed countries and small Taiwanese suppliers.

Vertical integration gives both Kingboard Laminates and Nanya Plastics economies of scale and a reliable supply of upstream materials. This allows both players to compete vigorously in the mass market, and during periodic raw material shortages, they can make extraordinary profits by raising selling prices, while their competitors are unable to do so for lack of product.

The stock was bought at about 11 times historic earnings, and at about 2 times net tangible assets. Trailing dividend yield was 4%. Debt to net tangible assets was about 27%, but cash on hand exceeded all short-term bank debt.

Yip's Chemical is a manufacturer of industrial chemicals such as solvents, inks, paints and lubricants. It was started in 1971 by Tony Ip and his sister Ip Fung Kuen. Their brother Stephen Yip joined in 1977. Yip's went public in 1991, and Tony and Stephen continue to run the business today as executive directors. Ip Fung Kuen recently retired on 1 April 2010, after 39 years of service.

Yip's is currently the low-cost producer for acetate solvents in southern China, with a 300ktpa plant there and a 60% market share. Eastern China is the next target market, and the company recently opened a 120ktpa plant there. Inks are sold to packaged-food manufacturers and offset printers who print glossy magazines.

Industrial paints are sold to suppliers manufacturing for the likes of **Mattel** and **Sony**, while household paints are sold to distributors under the *Bauhinia* brand name. *Bauhinia* is 4th in the market with about 5% market share, behind the leaders *Nippon Paint* (30%) and *Dulux* (15-20%). Yip's is now promoting *Bauhinia* aggressively with an advertising campaign on CCTV.

The lubricants business is not doing well, but fortunately it is small compared to the rest of the group. It currently doubles as a training ground for promising management trainees.

Overall growth is expected to come from acetate solvents, offset inks and household paints. All three businesses should benefit from both market growth and increased market share.

The stock was purchased at about 11 times forward earnings, and about 1.7 times net tangible asset value. Dividend yield was 5%. Debt to net tangible assets is 30%, but cash on hand exceeds all bank debt, and in any case the debt is seasonal, in line with sales patterns.

4. Accounting versus Reality

Financial statements prepared according to accounting guidelines form the starting point for investment analysis. Yet, it needs to be

recognized that accounting never fully reflects reality. At best, it is a "true and fair" view.

Usually, the auditors' unqualified opinion that the accounts are "true and fair" gives investors some comfort that the financial statements can be relied on to closely resemble the true state of affairs. But because accounting is based on *principles*, situations can arise when specific application of the generic principles results in accounts that are technically correct, but inaccurate in the practical sense.

These inaccuracies can arise almost anywhere in the financial statements. Because the cash flow statement shows the actual movement of cash, it is the least subject to interpretation and is perhaps the most "honest" type of financial statement. We will thus concern ourselves here with inaccuracies in the balance sheet and the income statement.

Current Assets generally refer to items of value that can be converted quickly into cash. Examples include bank deposits, inventories, publicly traded securities and trade receivables. **Inventories** are the problem here. While they are technically current assets, they are, practically speaking, fixed assets.

Take a department store which stocks goods for sale. Although the goods are current assets in the sense that they will generally be sold for cash within one year, they must then be replaced with similar goods i.e. the shelves must be restocked.

In other words, the inventories form part of the permanent working capital; they cannot be converted into cash for any real length of time without harming the business. A store with empty shelves will soon go out of business. As a result, it must be understood that in the case of a retail operation, the inventories are in fact fixed (non-current) assets in a very real sense.

Non-Current Assets are also subject to incorrect classification. Buildings are the quintessential fixed asset: big, expensive, and most of all, *immobile*. But all buildings are not alike. In real estate the oft-heard refrain is "location, location, location". Essentially, location determines both value and liquidity.

A large Grade A office building in the middle of the central business district of a healthy economy, and a decaying warehouse in a remote area with poor road access, would both be classified by accounting norms as non-current assets.

In reality, the Grade A office building, if put on the market at a reasonable price, would sell quickly. Sold at a small discount, it would likely move within a week. So for all practical purposes, the building is in fact a *current* asset from the owner's point of view, independent of how it is carried on the balance sheet.

On the other hand, the warehouse might actually be a liability, since it would attract property taxes, but not necessarily paying customers! Such an "asset" would be difficult to sell even at a deep discount to its book value. It might not even be possible to *give* it away.

Liabilities can be wrongly classified too. An example is deferred taxes. Deferred taxes arise when a company generates an accounting profit but is not required to pay taxes on it immediately. In some countries, the taxes are payable only when the profits are realized or repatriated.

But what happens when taxes are not even payable to begin with? Take SGX-listed **Hongkong Land**. Hongkong Land acquired its properties long ago. As an investment property owner, it has to revalue the properties from time to time. Current accounting rules require that when there are revaluation gains, deferred taxes must be provided on the capital gains, to be paid when the building is sold.

But in Hong Kong, capital gains are not taxable. Yet, accounting rules require that Hongkong Land *still* provide for deferred taxes on its balance sheet. In other words, Hongkong Land's balance sheet carries a liability that will never be paid.

For most companies, deferred taxes are not significant, because the properties are not large, or have not appreciated very much in value. But for Hongkong Land, the effect is to artificially depress the reported shareholders' equity by US$2bn, or almost US$1 per share. Essentially, when Hongkong Land shares sell at their reported book value, they are actually trading at a *discount* to their real value.

Consolidation is another area where the accounting presentation can differ from reality. The general rule is that a controlled entity is consolidated into the controlling shareholder's accounts. The trouble is that "control" can be interpreted creatively.

Usually, owning 50% plus 1 share i.e. absolute majority is taken to be the threshold for control and consolidation. But some companies own less than 50% and account for the entity in question as an associate, even though they *do* have effective control. In this way, problems at the controlled entity can be hidden from the holding company's minority shareholders.

Let us look at SGX-listed **Ezra Holdings**. Ezra accounts for its floating production arm **EOC** as an associate, on the basis that it does not control EOC. But according to EOC's own annual report, as of 10 Dec 2009, Ezra holds 48.6% of EOC. Ezra is by far the largest shareholder; the next-largest shareholder is Merrill Lynch International, with only 7.6%.

The chairman and vice-chairman of EOC are Lee Kian Soo and Lionel Lee, the same father-and-son team that runs Ezra Holdings as executive chairman and managing director. Furthermore, it appears Ezra has guaranteed the debts of EOC: Ezra's 2009 annual report shows it has issued corporate guarantees for US$157m of an associated company's debt[14].

Ezra records the total assets and liabilities of its associated companies; EOC accounts for the lion's share of both the assets and liabilities. It can therefore be safely concluded that at least some of EOC's debt is being guaranteed by Ezra.

EOC's own 2009 annual report shows that several of its loans (1, 2, 3, 8 and 9) are guaranteed by a related party[15]. These cover US$253m of the total US$378m in borrowings. Logically, Ezra and the Lee family are the only conceivable related parties that would actually want to guarantee any of EOC's debt. Ezra's guarantees cover only US$157m, so the remaining US$96m is probably guaranteed by some combination of Lee Kian Soo, Lionel Lee and Jit Sun Investments (wholly-owned by Lionel Lee).

Clearly, for all practical intents and purposes, Ezra controls EOC. So why would Ezra choose not to consolidate EOC into its accounts? A look at EOC's 2009 annual report provides some clues: the balance sheet is very weak, with only US$131m of equity supporting the US$378m debt load.

Consolidating EOC would therefore make Ezra's own balance sheet look bad. Of course, consolidation merely changes the accounting *presentation*; it does not change the reality that Ezra is already on the hook for at least some of EOC's debts.

We now move on to the **Income Statement**. Given the modern financial world's fixation on earnings, it is the financial statement most frequently used today. But it is also the statement with the most leeway in preparation, and thus the one most subject to manipulation.

Revenue is sometimes believed to be a more honest indicator than profits, on the basis that it is harder to manipulate. Unfortunately, companies do have some flexibility in how they recognize revenue. The biggest culprit is probably "fair value" changes.

Fair value changes with respect to investment properties have already been discussed in the context of **Hongkong Land**. The other type of

[14] p139, **Ezra Holdings Limited Annual Report 2009**

[15] p90-93, **EOC Limited Annual Report 2009**

fair value changes that can confuse readers is "biological asset" fair value changes.

Biological Assets are living things carried on the balance sheet. Examples include: timber plantations, fruit trees, cattle, fish or even abalone. Biological assets grow over time, so their value usually also increases over time. Timber plantations add wood and fruit trees mature, while cattle, fish and abalone increase in weight and thus market value.

In the case of biological assets, estimated fair value changes are used to reflect the fact that the assets and products are long-lived, and not sold the moment they increase in value. Years may pass between the time the assets are first acquired and when they are finally harvested. If the growth in the biological assets is not recognized, the financial statements become increasingly out of touch with reality.

As an extreme case, a timber plantation might have acquired its land 50 years ago at $10 an acre, and today the timber could be worth over $10,000 an acre. Without reporting fair value changes, only insiders would be able to have even a rough idea of the timber's true value.

Unfortunately, when fair value changes are reported in the income statement, they distort the picture as no cash has been generated yet. This is clear when one checks the cash flow statement and sees all the fair value gains reversed to reconcile the income statement with actual changes in the cash balance.

It would probably be a good idea to report fair value changes only in the balance sheet. Until that day comes, investors will have to undo the "fair value" gains themselves in order to work out the underlying profitability.

To complicate things further, some companies have chosen to use fair value accounting even though their assets and products are *not* long-lived. SGX-listed **China Milk** is one example. It maintains a herd of cows in China to produce milk, embryos and semen. It uses fair value accounting to estimate the value of milk sold, even though the milk that is produced is held for only a few hours at most, and once sold provides confirmation of the actual value.

Using fair value accounting for milk makes no sense at all, and results in the income statement becoming very difficult to understand. China Milk is currently in default of its convertible bond obligations, and its shares have been suspended from trading for over 2 months. Perhaps, as the story unfolds, more light will be shed on the financial statements.

So what do we take away from this brief look at how accounting can differ from reality? It is not that financial statements are worthless – in fact they are very valuable – but that it is imperative for investors to understand *how* the statements were prepared, in order to understand what the figures *mean* and not merely what the figures *are*.

Only when one understands the reality that led to the financial statements in their current form, can a useful analysis be made.

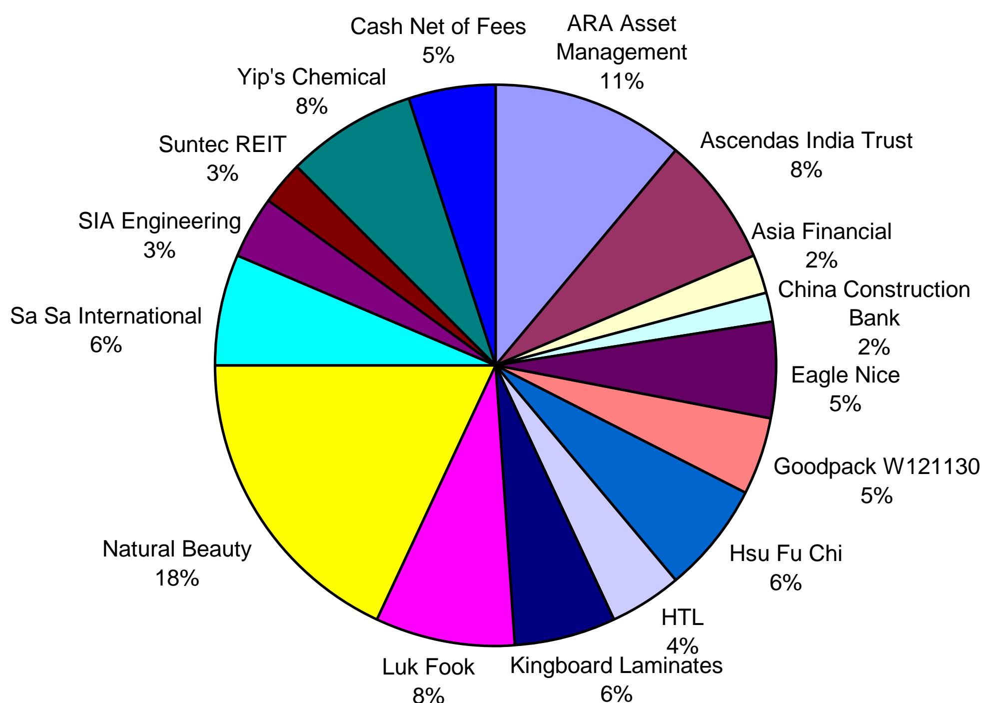
~ End ~

LIGHTHOUSE ADVISORS

Keeping Your Capital Safe

Annex I

Reference Account as of 31 March 2010



Annex II

Monthly NAV Values

Date	Net Asset Value per Unit	% Invested
30 Nov 2008	$100.00	16.20%
31 Dec 2008	$101.02	52.67%
31 Jan 2009	$103.03	52.65%
28 Feb 2009	$102.42	69.37%
31 Mar 2009	$100.11	51.35%
30 Apr 2009	$106.95	68.24%
31 May 2009	$131.61	77.07%
30 Jun 2009	$131.39	82.95%
31 Jul 2009	$142.18	85.58%
31 Aug 2009	$141.28	91.92%
30 Sep 2009	$146.38	94.84%
31 Oct 2009	$149.29	97.56%
30 Nov 2009	$154.88	94.34%
31 Dec 2009	$166.03	86.44%
31 Jan 2010	$164.00	83.96%
28 Feb 2010	$169.35	93.43%
31 Mar 2010	$179.88	94.92%