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 31 March 2011

1. Foreword

Fellow Investors,

Welcome to the Lighthouse Advisors newsletter for March 2011.

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

2. Market Commentary

It has been a volatile quarter in the markets. As at 31 March 2011, the US S&P 500 index was up 5.4% for the year, and the Dow Jones index was up 6.4%. London's FTSE 100 was flat with a gain of just 0.1%. In Asia, Japan's Nikkei 225 was down 4.6% and India's Nifty was down 4.9%, but China's Shanghai Composite was up 4.3%, while Hong Kong's Hang Seng Index was up 2.1%. In Singapore, the Straits Times Index was off 2.6%. While investors sitting on losses have little reason to be happy, we should all be grateful that any such losses involve only money and not lives.

Events in the real world have been disastrous, literally. As has been widely reported, on 11 March 2011, Japan was struck by a 9.0 magnitude earthquake, which triggered a tsunami that inundated many coastal regions. Entire towns were swept away as hundreds of thousands were evacuated. The death toll currently exceeds 25,000.

The earthquake-tsunami package culminated in the nuclear disaster at Fukushima when cooling systems for the reactors were overwhelmed: the earthquake shut down the reactors, then the tsunami damaged the backup diesel generators, and the last-defense battery-powered cooling systems ran out after 8 hours.

As a result, the water covering the fuel rods boiled off, the fuel rods melted, and radioactive isotopes were released, some in steam vented to relieve pressure buildup in the containment vessels, and some via water leaks into the surrounding sea. Containment efforts continue. Experts estimate that it may take decades for the reactors to cool down sufficiently to be considered stable.

In the meantime, Japan must grapple with whether and how it should rebuild the destroyed areas[1]. Many towns were already in decline due to Japan's economic malaise; it would make no sense to rebuild little-used facilities. And yet relocating the displaced population will be no easy task. In any case, there is now a 20-kilometre exclusion zone around Fukushima, which already guarantees that there will be thousands of refugees who need to be resettled.

Some optimistic investors have driven up the share prices of Japanese construction firms such as Kajima. Others – perhaps more realistically – have sold down the shares of Tokyo Electric Power Company (Tepco), the owner of the stricken nuclear plants. It remains to be seen whether either – or both – groups will be proven right. In the meantime, the Bank of Japan has downgraded its growth forecast for 2011 to just 0.6%, from 1.6% this past January[2].

Unrest in the Middle East continues. Hosni Mubarak is gone from power and under house arrest, but protests for further reform continue.

[1] *Tsunami Towns Face 'Empty Monument' Risk as Japan Rebuilds*, **Bloomberg**, 28 April 2011

[2] *Japanese Central Bank Cuts Growth Forecast*, **New York Times**, 28 April 2011

Updated 12 May 2011

Yemen's Ali Abdullah Saleh appears to be the next leader to go, though he has insisted on immunity to prosecution as a condition of stepping down, a condition that demonstrators so far are unwilling to grant.

While many neighbours initially cheered the "Arab Spring" – the apparent awakening of the Arab peoples in shaking off despotic regimes – regional governments have quickly become concerned that similar demands at home might unseat them too.

Some of the Arab regimes under popular pressure have taken the fate of the Tunisian and Egyptian leaders as signs that there is no way to leave peacefully, and have decided to stay in power by all means necessary[3]. The use of lethal force to break up public demonstrations has been a feature in Bahrain, Yemen, Syria, and, most obviously, Libya.

Libya's civil war is now the centre of attention. Many countries want the rebels to win, but few are willing to help directly. Neither Americans nor Europeans want their soldiers in Libya, while other Arab countries fear that overtly supporting Libyan "people power" may see their own regimes upended.

The UN has settled on a compromise: a "no-fly zone" to protect civilians from bombing by aircraft. The resolution was worded broadly enough that each UN member could interpret it as it wished. The doves thought (or hoped) it would merely lead to Libyan aircraft being grounded. The hawks, on the other hand, knew that it provided a valid pretext to preemptively strike the Libyan government's radar and anti-aircraft batteries, since a no-fly zone cannot be effective with such defenses active.

After initially leading the attacks, the US has handed over the command of the aircraft sorties to NATO. The aim of "civilian protection" has since been stretched a fair bit. While artillery and armour used to attack civilians have been destroyed, there have also been direct attacks on Colonel Gaddafi's compounds, with the latest such strike killing one of Gaddafi's sons and three of his grandchildren. This has only increased unease among those who question whether such operations are beyond the scope of the UN mandate[4].

Yet in some ways this is an easy war. Gaddafi is a pariah, unpopular even among his neighbours, and few will be sad to see him go. Some are now actively helping the rebels: Qatar has agreed to market oil held by the rebels and to help them buy fuel[5], while Egypt is supplying the rebels with small arms[6].

The real challenge will be if (when?) an equally repressive but Western-allied Arab nation, like Kuwait, Jordan, Bahrain or Saudi Arabia, devolves into civil war. Then the West will be torn between aiding a vital ally in an unstable region, and supporting the people's right to choose their own government, which is ultimately the ideal upon which their own governments are founded.

Practical geo-politics, or democratic ideals? So far, the West has chosen to sidestep this by looking the other way while these allies use force to disperse protesters and retain power.

The other recent violence of note is the killing of Al-Qaeda leader Osama bin Laden in Pakistan by a team of US Navy SEALs. While the killing was cheered in much of the Western world, there are also worries that it will spark fresh violence[7].

Most of the other news being reported is thankfully non-violent: it is merely jobs and not lives that are being lost.

---

[3] *Embattled Arab Leaders Decide It's Better to Fight than Quit*, **New York Times**, 27 April 2011

[4] *Gaddafi family deaths reinforce doubts about Nato's UN mandate*, **guardian.co.uk**, 1 May 2011

[5] *Qatar says marketing crude oil on behalf of rebels*, **Arab Times**, 13 April 2011

[6] *Egypt Said to Arm Libya Rebels*, **Wall Street Journal**, 17 March 2011

[7] *Nations Brace for Retaliation*, **Wall Street Journal**, 3 May 2011

In the US, the economic recovery continues to be a work in progress. The good news: unemployment fell to "only" 8.8% in March. The bad news: house prices fell for the eighth month in a row in February. Among homeowners with outstanding mortgages, over one quarter now have mortgages that exceed the value of their homes[8]. Those hoping for a US consumer-led revival are still waiting.

In Europe, the PIGS situation is starting to near a resolution. Portugal has now joined Ireland and Greece in asking for a bailout, leaving Spain as the last holdout.

Practically speaking, Spain will not be allowed to collapse: given its relative size in the EU, many other countries will be badly affected if Spain cannot function normally. Essentially, the only variable is what Germany will extract in fiscal reform as a condition of aid: nothing if Spain somehow survives the recession alone, and budget cuts and tax hikes aplenty if Spain asks for help.

In Asia, China and India remain the main drivers of economic growth. The IMF's latest estimate is that China and India will grow 9.5% and 8.2% respectively in 2011, far outpacing the US and Europe.

At the risk of sounding like a broken record, your manager continues to focus on Asia, especially in Hong Kong, where there is an abundance of companies operating in China, whether to serve the domestic market or to manufacture for export. Some of these companies are exceptionally well run. Occasionally, they are available at reasonable prices. That is when they are attractive investments, and your manager will strike.

There is still nearly two-thirds of the year to run. While one might daresay that the world has seen enough turbulence for a full year, nobody knows what else may come. Your manager remains comfortable with the portfolio's current holdings in well-managed, conservatively financed companies, and will write again when the report for the quarter ended 30 June 2011 is ready.

Benjamin Koh
Investment Manager
Lighthouse Advisors
12 May 2011

3. Portfolio Review

As at 31 March 2011, the Reference Account Net Asset Value (NAV) was $219.13 per unit, net of all fees. The highwater mark was $228.60, and the total return to date for 2011, net of all fees, was -4.1%.

16 securities made up 85.8% of the Reference Account, with the balance in cash. A pie chart is in Annex I, while NAV values are tabled in Annex II.

Divestments

Dah Chong Hong (DCH) was sold in the wake of the Japanese triple disaster that disrupted Japan's industrial production chain. DCH primarily sells Japanese cars. Some marques, like Lexus, are made in Japan, while others are made in China. However, the China-made cars still depend on key components sourced from Japan, so there will still be disruption to the supply of cars available for sale. The supply chain is likely to take at least a year to return to normal.

As the stock had also appreciated significantly since the initial purchase, your manager took the opportunity to exit. In local currency (HKD) terms, the gain on sale was about 33%.

New Investments

Pacific Textiles is a manufacturer of high-end fabric. It buys yarn and converts it into fabric, while dyeing or printing it. It specializes in complex fabric such as lingerie, and counts

[8] *U.S. 'Underwater' Homeowners Increase to 28%, Zillow Says*, **Bloomberg**, 9 May 2011

Triumph and Victoria's Secret among its end-customers.

Pacific Textiles only went public in 2008, but the key executives all have over 25 years' experience in the industry. Several trace their lineage back to Fountain Set, one of the world's largest circular knit fabric makers. Three of the executive directors were executive directors there, while chairman emeritus Choi Kin Chung is a co-founder and former vice chairman of Fountain Set.

The public data available for Pacific Textiles shows that it has done quite well. In the last 6 years, its net margin averaged 12%, and return on equity averaged 26%. Even in the crisis years of 2008-2009 the company managed to earn 8-9% on sales, and 12-13% on equity.

At investment, the company's shares sold for about 7 times the trailing 12 months' earnings and at about 2 times book value. Dividend yield was 7%, while debt to equity was just 2%. Cash on hand exceeded all liabilities.

Texwinca is also a manufacturer of fabric. Unlike Pacific Textiles, it focuses on basic, high-volume textiles.

Texwinca is the world's largest fabric producer by dyeing capacity. As such, it is also the lowest-cost producer. In the last 5 years, wages per worker jumped 50% but gross margins in the fabric and yarn segment actually increased. This suggests some degree of pricing power. In fact, Texwinca makes most of its money from "rush" orders, when customers are in a hurry and pay up for quick delivery.

Texwinca's management estimate that its global market share is only 4%, so there remains plenty of room to grow. As environmental regulations become stricter, smaller players will exit, giving large players like Texwinca an increased market share and further economies of scale.

Texwinca also owns the *Baleno* brand of apparel, which now contributes about 47% of revenues but only 25% of profits. Profit contributions should improve shortly: stores in Hong Kong and Taiwan have been consolidated, while *Baleno* has exited Singapore and Malaysia entirely due to limited potential. China is the main focus and continues to grow rapidly. *Baleno* has been the top-selling brand of T-shirts in China for several consecutive years.

Texwinca's public track record goes back to at least 1994. Throughout this period it has never lost money. In terms of returns, in the worst year, FY2006, it still earned 6% on sales and 17% on equity. Public data shows that the company's book value per share compounded at 13% per year from 1997 to 2010, while it averaged a 49% dividend payout ratio. In recent years the payout ratio has actually hovered around 60%.

At investment, the company's shares sold for 10 times the trailing 12 months' earnings and about 2 times book value. Dividend yield was 6%. Debt to equity was 33%, and cash on hand exceeded all debt.

<u>Other Significant Events</u>

Ascendas India Trust announced plans to acquire 5 buildings in Hyderabad over the next 4-5 years. This will add 2.2m sqft of space, a significant increase over the 5.9m sqft currently owned. The acquisition can be fully debt-funded, so equity fundraising is unlikely at this point. Two of the buildings comprising 0.4m sqft will be added immediately and will be yield-accretive.

4. Headcount

Too often, investors rely only on the three financial statements produced by companies: the income statement, the statement of cash flows, and the balance sheet. While the financial statements are the foundation upon which an understanding of the business is built, useful information can also be drawn from other disclosures by the company. For example, the headcount reported by the company can yield valuable clues to the nature of the business – is the business more dependent on machinery, or on employees? Are the employees performing basic, repetitive, low-wage tasks, or are they performing complex, highly value-added work that requires unusual skill or knowledge?

The reported headcount can also serve as a sanity check when used in conjunction with the financial statements to arrive at per-person figures such as sales per employee, wages per employee or production volume per employee.

Per-employee figures can sometimes raise red flags when the company's numbers look very different from other companies in the same or similar industries. In some cases, wages per employee may be abnormally low. In others the reverse may be true. Also, trends in per-employee data can also yield important clues; they are a measure of productivity and hint at whether things are getting better or worse. If the trends are unusual they may also suggest a need for further investigation.

Let us look at productivity. Commonly defined as the output per worker per unit of time, it can be measured directly in terms of widgets produced, or indirectly in terms of sales per worker. In manufacturing and services alike, there is a limit to how fast workers can do their job; doubling pay does not double output. Improvements tend to be incremental and follow improvements in business processes.

Large changes in productivity are usually indicative of massive internal changes. If a company was poorly run and is now under capable management, rapid improvements are of course possible, but once the company has been brought up to scratch, the rate of improvement goes back to normal.

Adoption of a disruptive process, for example mechanization of a formerly manual process, may produce large one-time jumps in productivity, but subsequent improvements are again incremental.

What all this means is that in a competitively-managed company, productivity will be relatively stable over time. It may rise slowly as the management makes improvements to business processes, with step-jumps in years when entirely new processes or technologies are adopted. But for the most part it should change very little through the business cycle.

Conversely, if productivity rises rapidly for several years in a row, something unusual is going on. Either the company was so poorly managed previously, that each year the new management can attain sizeable improvements over the previous year, or the company is now making products of much higher value, or in much greater volume, than before. Of course, there is also the cynic's view: the company may be cooking the books…

A case study may prove illustrative. **Qingmei Holdings** is a sports shoe sole manufacturer in Jinjiang City, Fujian Province, China. The company was listed on the Singapore Exchange in March 2010. For the year ended 30 June 2010, it reported sales of RMB 1.2bn. This was a 42% increase over 2009. Growth in previous years was equally impressive: FY2009 sales were 33% above those of FY2008, which were themselves 113% above those of FY2007, the earliest year for which results are available.

The company reported that sales volume rose from 11.8m pairs of soles in FY2007 to 44.3m pairs in FY2010. This amounts to a compounded growth rate of 55% per year over three years. For a company of any meaningful size, this is an outstanding achievement. But for Qingmei these impressive output numbers pale against the per-employee figures.

During these 4 years, physical output more than tripled. Yet in the same period, the size of the workforce barely budged. On 30 June 2007 there were 3,149 employees producing 11.8m pairs of soles, or 3,744 pairs each. The next year there were 3,307 employees producing 23.9m pairs, or 7,223 pairs each. For FY2009, 3,597 employees made 30.9m pairs, equivalent to 8,589 pairs each.

For 30 June 2010 the exact headcount was not disclosed, but on 17 December 2009 there were 3,591 staff, and on 14 February 2011 the CFO disclosed in a briefing that there were currently "about 3,500" employees. Suppose we take an average, getting 3,546. We then have 3,546 people producing 44.3m pairs in FY2010, or 12,495 pairs of shoe soles each.

What is one to make of these numbers? Clearly, there were startling improvements in output per worker. In FY2008 the improvement was a mind-boggling 93%. In FY2009 it was a still-excellent 19%, and in FY2010 it was again an amazing 45%.

Did the company buy some automation equipment and adopt some transformational manufacturing technology? **No.** The CFO stated in a briefing on 14 February 2011 that the production process was fairly low-tech, with little scope for automation.

Was the company so poorly managed before that when new management took over they were able to effect rapid productivity gains for 3 straight years? Probably not. The founders Su Qingyuan, Su Qingjiang and Su Shubiao have been in charge since the company's founding in 2003. So there were no major changes in management.

The numbers also do not suggest a poorly managed company, but quite the contrary: for FY2007 the company reported a 16% net margin on sales, and it earned 47% on equity. Adjusted for a related party loan, it still earned 26% on equity, an excellent rate of return. Any manufacturing company reporting such numbers would normally be considered to be running at or near its optimum capacity, with little room for efficiency improvements.

But if there was no adoption of advanced technology, no management shakeup, and we accept that better manufacturing processes yield only incremental improvements, the only answer left is that the company's workers are supermen whose output has improved greatly every year for 3 straight years. That this is ridiculous goes without saying.

Yet, if we dismiss the supermen theory on the grounds of implausibility, we are left with the cynic's conclusion that, notwithstanding the auditor's opinion that the financial statements are "true and fair", the numbers reported by the company must be inaccurate in some fashion, and that the company's shares are to be avoided at all costs. For if the data provided by the company cannot be relied upon, there is no longer any basis for investment.

One might look at other per-employee figures and see if there are further clues to this mystery. The wages per employee seem to draw some attention here.

In Fujian Province, the highest minimum monthly wage as of March 2010 was RMB 900, or RMB 10,800 annually. For the year ended 30 June 2010, Qingmei paid its workers about RMB 50,000 each. Certainly, Qingmei can pay its workers more than the minimum wage to keep them motivated and productive. But are its workers truly more than *four times* as productive as the average minimum-wage worker? *Can* its workers be four times as productive, given the manual, low-tech nature of the company's production?

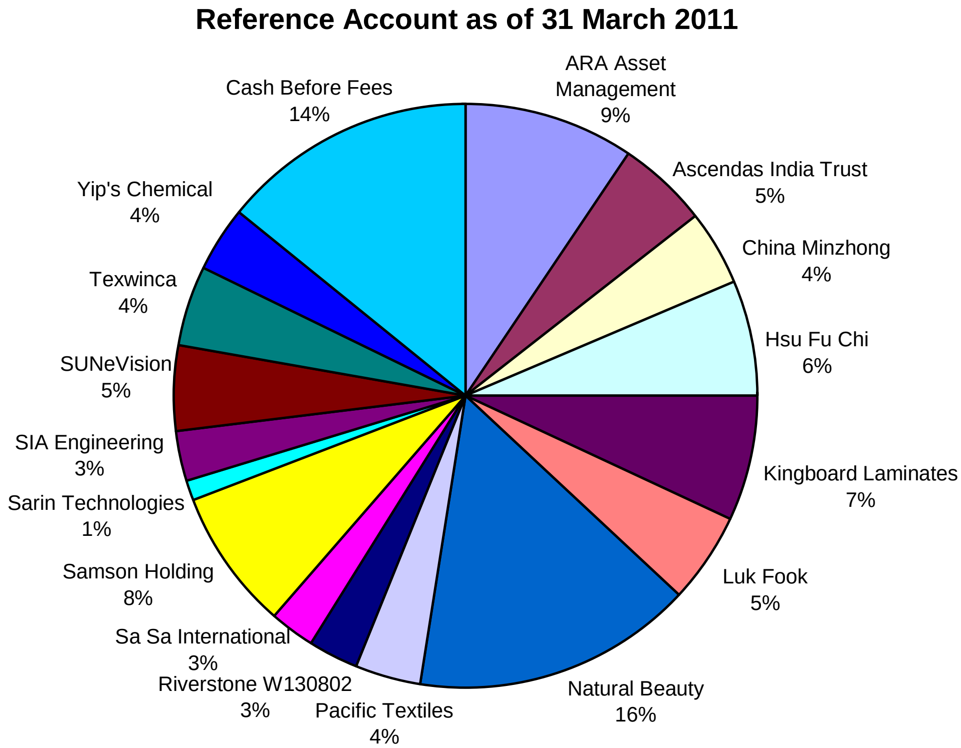
Perhaps supermen deserve super wages. Perhaps some of the reported salary expenses are not in fact being paid to the workers. Perhaps there are many more workers than officially reported, since undocumented workers can be paid less or denied benefits. Perhaps, perhaps, perhaps. We do not know.

In any case, the point of this analysis is to show that the headcount reported by the company can be a useful sanity check.

As for Qingmei, the truth will emerge one day. In the meantime, the prudent investor would do well to wait on the sidelines.

End

Annex I



Annex II

Monthly Net Asset Values								
	2008		2009		2010		2011	
Date	**NAV**	**Invested (Gross)**	**NAV**	**Invested (Gross)**	**NAV**	**Invested (Gross)**	**NAV**	**Invested (Gross)**
31 Jan			$103.03	52.48%	$163.97	83.91%	$220.13	86.53%
28 Feb			$102.42	69.23%	$169.35	93.00%	$216.56	93.66%
31 Mar			$100.11	51.25%	$179.88	93.26%	$219.13	85.79%
30 Apr			$106.95	67.37%	$184.58	90.31%		
31 May			$131.61	73.01%	$177.16	80.77%		
30 Jun			$131.39	78.62%	$180.97	84.17%		
31 Jul			$142.18	80.00%	$189.62	86.50%		
31 Aug			$141.28	86.22%	$193.05	92.43%		
30 Sep			$146.38	88.44%	$210.53	99.04%		
31 Oct			$149.29	90.70%	$213.32	95.13%		
30 Nov	$100.00	16.19%	$154.88	87.41%	$221.65	92.52%		
31 Dec	$101.02	52.56%	$166.03	79.26%	$228.60	85.71%		
YTD	**+1.0%**		**+64.4%**		**+37.7%**		**-4.1%**	