LIGHTHOUSE ADVISORS
Keeping Your Capital Safe

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Client Newsletter for the period ended 30 September 2012

1. Foreword

Fellow Investors,

Welcome to the Lighthouse Advisors newsletter for September 2012.

The fund is unfortunately still not yet finalized. Stay tuned.

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

2. Market Commentary

The stock market rollercoaster continues amidst the uncertain economic climate.

Perhaps one way to understand the world economy is to view it through the lens of the world's major industrial companies – those who provide goods and services that are needed for economic activity such as construction, transportation and general commerce.

Caterpillar, the world's largest company in construction and mining equipment, reported stellar results for the quarter ended 30 Sep 2012, but cut its 2012 forecast for the second time, and indicated that no improvement was expected until the second half of 2013.

Rusal, the world's largest producer of aluminum, reported a loss for its half-year results ended June, amid falling prices for aluminum.

Frontline, which operates one of the world's largest fleets of oil tankers, reported losses for the June quarter and noted that losses on some of its routes were the worst ever (since 1990). Tanker supply continues to exceed demand.

Vale SA, the world's largest producer of iron ore and the world's second largest producer of nickel, reported a 34% decline in its June half-year operating income. The average selling price of iron ore fell 22%. Iron ore pellet prices dropped 17%, while nickel fell 29%.

Other examples abound, but the point should be clear – the world economy is in a funk.

The US economy continues its agonizing crawl towards normality. One faint glimmer of hope: unemployment at end-September was 7.8%, the best so far for 2012[1].

In Europe, the picture is getting bleaker. In Spain, unemployment for those under 26 is now 50%, and despite an austerity budget, debt is expected to rise to 90.5% of GDP in 2013[2]. Even in Germany, the last bastion of economic strength in the European Union, the crisis is starting to hurt: the Bundesbank now expects the economy to stagnate or even shrink by the end of the year[3].

Japan's woes seem to be never-ending. After the tragic earthquake-tsunami last year, the latest problem is political: the ongoing dispute over the Senkaku / Diaoyu islands has cut into sales of Japanese products in China, and Chinese tourist visits to Japan are down. Sovereignty questions aside, the islands are also a convenient way for the Chinese government to distract its own citizens from

[1] *The Employment Situation – September 2012*, **Bureau of Labor Statistics**, 5 October 2012

[2] *Spain debt rises on aid to banks, regions, finance cost*, **Reuters**, 30 September 2012

[3] *Germany may see economy shrink in fourth quarter*, **BBC News**, 22 October 2012

the economic slowdown and political machinations at home.

In China, the government is still cleaning up the Bo Xilai saga. The leadership has apparently agreed to demonize Bo Xilai; he has been stripped of party membership and accused of a litany of vices, from bribery to adultery, and charged with murder[4].

The downfall of Bo benefits Hu Jintao's faction, but a separate scandal has also damaged his side. Three days after Bo was removed as Chongqing party chief in March, Hu Jintao's closest confidant, Ling Jihua, lost his son when the latter crashed a Ferrari at 4am on a Beijing road[5]. The son, Ling Gu, died on the spot. News of the crash has been scrubbed from the mainstream media, and Ling Gu's Peking University classmates were told he had "gone overseas". Ling Jihua was not publicly censured, but six months later he was transferred to a less important job, crystallizing an erosion in Hu's support base.

Obviously, the Bo and Ling cases have distracted the ruling party from their real job of running the economy. Coal and iron ore are key inputs for China's industrial economy, as they are the raw materials for generating electricity and manufacturing steel. Prices for both bellwether commodities have fallen this year, which suggests that the industrial economy is growing far more slowly than the government would like the world to believe.

Domestic competition continues to be intense, with fashion retailers and supermarkets alike facing a margin squeeze. The luxury segment has not been spared, as even the rich now find better value shopping overseas in Hong Kong or even Paris.

Syria continues to hog the headlines in Africa for all the wrong reasons. Tension with Turkey has also complicated the Syrian civil war. Turkey hosts much of the anti-Assad rebellion and about 100,000 Syrian refugees. The violence along the border has resulted in artillery shells occasionally landing in Turkey, and Turkey has fired back in retaliation. It also recently forced a Syrian passenger jet to land in Ankara and confiscated cargo it described as missile parts[6].

All in all, globally it is business as usual i.e. the world remains a mess. Therefore locally it is also business as usual i.e. your manager remains focused on finding suitable investment-worthy securities.

Your manager will write again when the report for the quarter ended 31 December 2012 is ready.

Benjamin Koh
Investment Manager
Lighthouse Advisors
5 November 2012

3. Portfolio Review

As at 30 September 2012, the Net Asset Value (NAV) of the Reference Account was $195.10 per unit, net of all fees. The highwater mark was $228.60. Against the end-2011 NAV of $186.42, the year-to-date return for 2012, net of all fees, was 4.7%.

19 securities made up 89.1% of the Reference Account, with the balance in cash. A pie chart is in Annex I, while NAV values are tabled in Annex II.

<u>Divestments</u>

Sincere Watch HK was divested when a pattern of unusual trading activity emerged after Pollyanna Chu's mandatory general offer. The offer resulted in the free float falling below stock exchange requirements,

[4] *Bo Xilai case: sex, bribes and murder – China throws the book at former hero*, **The Telegraph**, 28 September 2012

[5] *Crash Puts New Focus On China Leaders*, **The Wall Street Journal**, 22 October 2012

[6] *Turkey, Seeking Weapons, Forces Syrian Jet to Land*, **New York Times**, 10 October 2012

and the stock was suspended while shares were placed out.

Shortly after trading resumed, the stock surged on heavy volume. As the volume of shares traded was close to the number of shares that were placed out, it hinted at the market being manipulated to allow the placement participants to exit at a profit. Your manager decided to join the party and sold the shares. The gain on divestment was over 50%.

New Investments

Chow Sang Sang is a Hong Kong-based retailer of gold and gem-set jewellery. It traces its roots back to a jewelry business founded in the 1930s in Guangzhou, China. Today, the listed company operates 57 stores in Hong Kong and Macau, 21 stores in Taiwan and 249 stores in China. It also operates a small stockbroking operation.

Unlike key rivals Chow Tai Fook and Luk Fook, all of Chow Sang Sang's stores are self-operated. While this allows Chow Sang Sang to maintain full control, it also requires more working capital to stock the stores. As a result, Chow Sang Sang has incurred some debt in its expansion.

The growth in Chow Sang Sang's book value over the years is distorted by its shares in Hong Kong Exchanges. When the exchange demutualized and went public, Chow Sang Sang received shares in the listed company. Unlike many other jeweler/stockbroker rivals, Chow Sang Sang has held on to the shares.

Stripping out the value of the Hong Kong Exchange shares, Chow Sang Sang's adjusted book value has compounded at 15% per year over the last 9 years. Return on adjusted equity averaged 13% over the same period. The dividend payout ratio averaged 48% of total reported profits.

The shares were purchased at about 10 times trailing earnings and about 1.7 times book value. Debt to equity was about 30%. Dividend yield was about 4%.

CSE Global is an engineering services company specializing in automation for the oil and gas industry. It is a global business with revenues almost evenly spread across its 3 major markets of the Americas, Asia Pacific, and Europe including the Middle East and Africa.

CSE started in 1985 as the Engineering Projects Division of Chartered Electronics, the electronics arm of Singapore Technologies. It entered the oil and gas industry in 1989, and the information technology industry in 1994. In 1996 CSE had a management buyout, and in 2000 it was listed on SGX.

CSE has grown primarily by acquisition. Since 2000, it has spent over $100m buying and integrating other engineering services companies. By and large, these have been successful, with annual revenue now exceeding $450m, compared to $100m just after IPO. More importantly, profits in recent years have crossed the $40m mark, against $14m in 2000. Adjusted return on equity has averaged 28% in the last 12 years, despite "dead" intangible assets making up half or more of the equity base during this time. Dividend payouts in recent years have averaged 40% of profits.

The shares were purchased after a decline in the price caused by a one-time drop in profits. A project in the Middle East required local procurement, which the local manager overlooked. Rectification created a cost over-run. The company made a large provision for the project and replaced the manager in question. Given the company's track record, it seems likely that this lesson will be learnt and similar mistakes avoided in future. The latest quarterly results indicate that the company is back on track.

The shares were bought at about 8 times adjusted earnings, and about 2 times book value. Expected dividend yield was about 5%.

k1 Ventures is a diversified investment company which operates as a private equity fund. There are 5 major investments: Helm

Financial, a US-based railcar and locomotive leasing company, Knowledge Universe, a provider of pre-school and secondary education in the US, UK and Singapore, McMoran Exploration, a listed oil-and-gas exploration and production company, Guggenheim Capital, a financial services group, and China Grand Auto, one of the largest automotive dealership groups in China.

Helm is 80.1% owned and consolidated, while the other investments are minority stakes carried at adjusted cost.

Helm owns a fleet of 550 locomotives and 5,162 railcars. It also operates 2 railcar joint ventures, one with Union Pacific Corporation and another with CSX Corporation and Diamond Rail Lease Corporation. The joint venture fleet includes 8,119 railcars, 70 locomotives and 1,259 autoracks.

Some of Helm's locomotives are six-axle locomotives, for which demand has fallen, and in FY2011-2012 Helm took a large impairment charge. On the other hand, railcar leasing demand has been strong, with utilization rates now at 95% versus 85% a year ago. Helm recently acquired 711 railcars and 10 locomotives, and committed US$50m to refurbish 102 GP38-2 locomotives, which suggest that the outlook is positive despite the impairment charge.

k1 owns 12.2% of Knowledge Universe Holdings, which owns 65% of Knowledge Universe Education LP, which in turn owns 100% of Knowledge Universe Education LLC. Collectively, the Knowledge Universe group operates over 3,000 locations worldwide, employing 40,000 professionals and serving 300,000 students daily.

As k1 owns only a minority stake in Knowledge Universe, there is little disclosure available. However, it has been estimated that the real estate underlying Knowledge Universe LP's operations is itself worth approximately US$1bn before factoring in debt. Additionally, one of Knowledge Universe's investments, EmbanetCompass, a provider of online learning solutions for universities, was recently sold to Pearson for US$650m.

Knowledge Universe's sales of non-core assets and resultant cash distributions have already exceeded k1's cost of investment. It is likely that k1 will realize significant additional gains on its stake in Knowledge Universe.

McMoran Exploration is listed on the NYSE. k1's stake is approximately 1.5%.

The Guggenheim Capital investment is in the form of US$100m in preferred units paying a 7% coupon, with warrants to subscribe for equity. There is a put option in 2017.

China Grand Auto's key subsidiary is Guanghui Automobile, and k1's effective stake is 1.6%. Guanghui has recently filed for a listing in Shanghai. Should the listing occur, k1 should realize significant profits.

Although there is no clear timeframe for when the investments will be realized, there was a recent offer by the Chairman and CEO to privatize k1, which did not succeed. The offer suggests that there is substantial unrealized value even at the offer price. The shares in k1 were acquired at about the offer price, which represented a 50% discount to the estimated revalued net asset value. Dividend yield was about 4%.

Permanent impairment seems unlikely at the price paid. The main uncertainties lie in when the investments will be fully realized, and how much will eventually be returned to shareholders.

Nera Telecommunication (NeraTel) is a provider of telecommunications solutions. It operates in the satellite communications industry, where it sells and installs receiving equipment and communications terminals, and the information technology network industry where it provides network equipment and payment solutions. Originally, a significant proportion of the equipment was supplied by Nera ASA, its holding company (which has since merged with Eltek ASA).

As a service-oriented business, NeraTel requires very little capital to operate. As a result, it has historically generated significant quantities of free cash, with over 80% of reported profits converting to free cash during 2005-2011. The cash has in turn funded generous dividends to shareholders.

NeraTel is today 50.05% owned by Eltek ASA, which is listed in Oslo. Eltek sold off Nera Networks to Ceragon Networks in 2011, at which point NeraTel became an "orphan" available-for-sale asset.

On 10 February 2012, Singapore Technologies Electronics, a 100% subsidiary of Singapore Technologies Engineering, announced an acquisition of NeraTel via a scheme of arrangement. However, the scheme was defeated by minority shareholders at an extraordinary general meeting on 6 July 2012.

Shortly after the deal fell through, the shares of NeraTel fell below the proposed acquisition price, at which point your manager decided to buy in. NeraTel is a "special situation" type of investment. At some point the company will be sold, but at a higher price. In the meantime, shareholders can expect to collect dividends, so they are literally being paid to wait.

The shares were acquired at about 8 times trailing earnings and about 2.5 times book value, at an estimated dividend yield of 9%.

Other Significant Events

LMA International has received a takeover offer from Teleflex, a NASDAQ-listed medical device distributor. The offer was structured as an asset purchase agreement to buy LMA's assets, after which LMA will liquidate and distribute the proceeds to shareholders. The buyout premium is approximately 50% over the market price before the agreement.

The agreement has since been approved by shareholders via extraordinary general meeting on 19 October 2012. There will be an advance distribution in November, after which LMA will be delisted. The final distribution, net of liquidation expenses, will be paid in February. The gain on divestment should exceed 80%.

4. Rule of Law

Rule of law in the investment context refers to the idea that all the players are bound by the same rules, and that disputes and breaches are fairly addressed in court. This is especially important to professional investors who specialize in distressed investing, where their gains often come from someone else accepting a large loss, willingly or otherwise.

Bankruptcy legislation is well-developed in the US under Chapter 11 of the Bankruptcy Code. As a result, many professional investors have found it worthwhile to buy the debt of distressed entities and restructure them. Under Chapter 11, such investors can wipe out shareholders, appoint themselves as the new shareholders, and thereby acquire a debt-free company, often at a significant discount to a comparable going concern.

Even for non-distress investors, the rule of law is important in determining seniority. When companies are under financial stress, seniority can determine who gets paid and who does not. This creates price differentiation: senior debt pays a lower coupon, in line with its lower perceived risk, while the converse is true for junior debt.

Sadly, outside the US and Western Europe, the rule of law is not straightforward. Many investors have discovered to their dismay that unwritten rules can matter even more than official rules.

Two case studies will be discussed here: China Yuchai and Churchill Mining.

China Yuchai, via its 76.4% stake in Guangxi Yuchai Machinery, is a manufacturer of diesel engines used in cars, buses and trucks. It is listed on the New York Stock Exchange. China Yuchai is 34.9% owned by **Hong**

Leong Asia (HLA), which is itself listed on the Singapore Stock Exchange. HLA also owns a special share in China Yuchai, which confers on HLA the ability to elect a majority of the directors. Since the executive directors run the business of the company, the special share effectively gives HLA control of China Yuchai, and thus Guangxi Yuchai.

However, in 2004, HLA discovered that its special share conferred control in name only. The politically connected chairman of Guangxi Yuchai, Wang Jianming, had diverted company funds to an unauthorized loan and refused to allow Guangxi Yuchai to pay dividends that had been declared. It took HLA more than a year of negotiation with the Chinese government to replace Wang with someone friendly to HLA. And who was the new chairman of Guangxi Yuchai? Yan Ping, another well-connected official in Yulin, where Guangxi Yuchai's plant is located. So although HLA had legal control, it still required the help of a friendly agent to enforce it. At least this saga had a happy ending.

Churchill Mining is a mineral exploration and mining company. It was floated on London's AIM in 2005.

Churchill Mining began exploring for coal in Indonesia in 2008, after it bought a 75% interest in 4 mining licenses issued in 2007 to companies under the Ridlatama group. The licenses were in the East Kutai district of East Kalimantan, an area linked to the politically connected Nusantara Group, which had allowed its licenses to expire. But shortly after Churchill announced the discovery of a 2.7bn ton thermal coal deposit in the area, the district head (*bupati*) extended Nusantara's expired licenses.

(Nusantara is owned by Prabowo Subianto, the former commander of Suharto's Kopassus special forces unit. Other shareholders in Nusantara's coal interests include Anthony Salim, Indonesia's fifth-richest man.)

After extending its licenses, Nusantara complained that Ridlatama's licenses were fraudulent. Indonesia's state audit agency (BPK) asked East Kutai's auditor to investigate. The auditor reported that Ridlatama's licenses were genuine – and was fired for *producing a fake report*.

The bupati later revoked Ridlatama's licenses for illegal logging in an indigenous (dayak) community, even though the local dayak chief clarified that it was *the dayaks themselves who had cut the trees* to build a communal building and a church, which they were allowed to do.

Churchill's predicament was profiled in the *Sydney Morning Herald* last October and in the *New York Times* this past June. The company is currently seeking arbitration over the dispute at the International Centre for Settlement of Investment Disputes in Washington, DC.

What can investors take home from these 2 case studies?

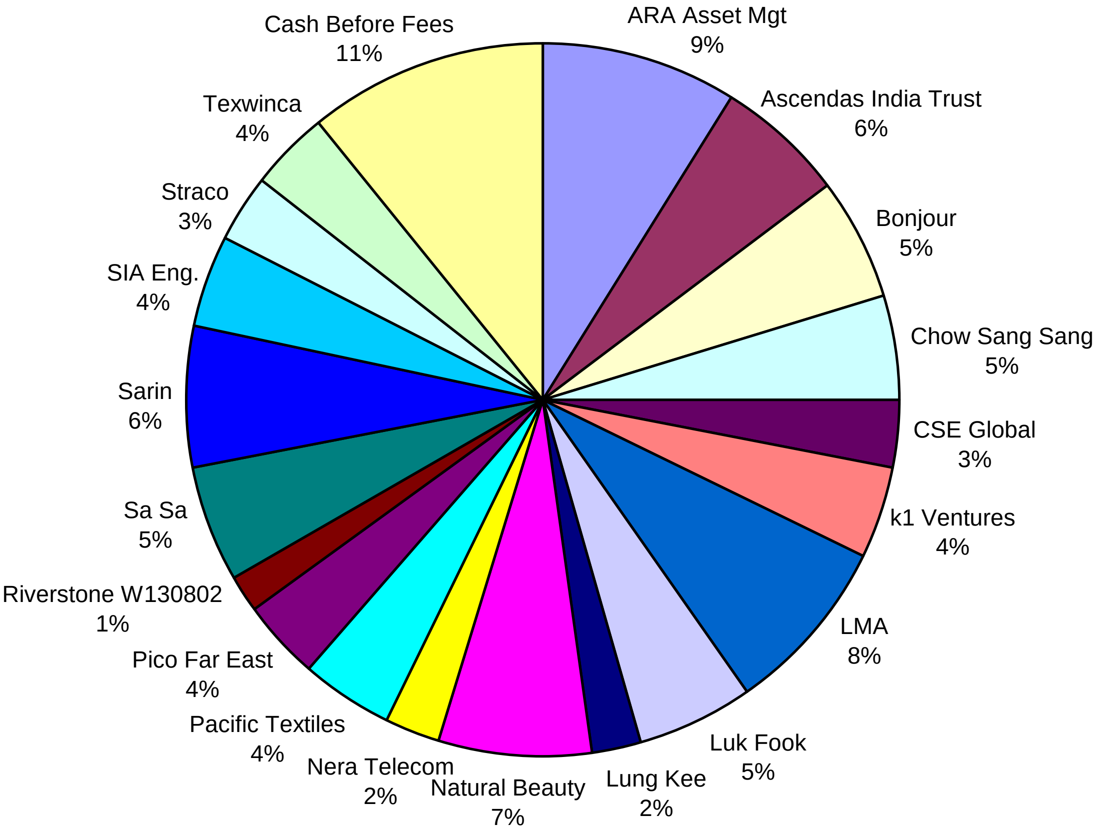
First, do not rely solely on the law. The local government can and will change the law or even ignore it if it suits its own interest. Those who invest into politically sensitive sectors such as banking, utilities and mining would do well to ensure that the deal is seen as a win-win for everyone, not merely the investors. A "foreigner wins, local loses" situation is vulnerable to attack.

Second, ensure that there is alignment of interest. Parties with influence over the deal will do all they can to reap some benefits. A deal that excludes them is at risk of being challenged.

End

Annex I

Reference Account as of 30 September 2012



Annex II

Monthly Net Asset Values										
	2008		2009		2010		2011		2012	
Date	NAV ($)	Invested (Gross)	NAV ($)	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%	192.15	73.35%
28 Feb			102.42	69.23%	169.35	93.00%	216.56	93.66%	204.12	79.44%
31 Mar			100.11	51.25%	179.88	93.26%	219.13	85.79%	204.78	79.53%
30 Apr			106.95	67.37%	184.58	90.31%	224.22	86.13%	203.33	84.41%
31 May			131.61	73.01%	177.16	80.77%	221.20	87.01%	194.22	82.27%
30 Jun			131.39	78.62%	180.97	84.17%	221.25	86.70%	192.88	81.41%
31 Jul			142.18	80.00%	189.62	86.50%	216.53	83.65%	189.64	84.69%
31 Aug			141.28	86.22%	193.05	92.43%	198.69	82.60%	191.78	86.68%
30 Sep			146.38	88.44%	210.53	99.04%	177.28	84.05%	195.10	89.06%
31 Oct			149.29	90.70%	213.32	95.13%	193.17	83.38%		
30 Nov	100.00	16.19%	154.88	87.41%	221.65	92.52%	184.76	83.96%		
31 Dec	101.02	52.56%	166.03	79.26%	228.60	85.71%	186.42	76.01%		
YTD	**+1.0%**		**+64.4%**		**+37.7%**		**-18.5%**		**+4.7%**	