LIGHTHOUSE ADVISORS
Keeping Your Capital Safe

54A Amoy Street
Singapore 069880
Tel (65) 9040 9813
www.lighthouse-advisors.com

Client Newsletter for the period ended 31 December 2012

1. Foreword

Fellow Investors,

Welcome to the Lighthouse Advisors newsletter for December 2012.

The fund is in the final stages. Your manager has also applied to the Monetary Authority of Singapore for registration under the new regulations.

This newsletter follows the same format as previous issues. The special topic for this issue is **Fair Value and Biological Assets**.

2. Market Commentary

Stock markets in Asia rallied strongly in the fourth quarter to end the full year with significant gains. Singapore's FSSTI finished the year with a gain of 19.7%. Hong Kong's Hang Seng Index was up 22.9% while Japan's Nikkei 225 rose 22.9%.

This occurred despite the ongoing economic problems in Europe and the political stalemate in the US, so either stock markets are inefficient, or politicians are in fact economic miracle workers.

The problems in Europe do not need repeating. The US "fiscal cliff" has similarly hogged headlines at many newspapers.

China's manufacturing engine is starting up again, as both domestic consumer demand and more outsourcing investments from Europe, Japan and the US encourage factory expansion[1]. For December, China's official Purchasing Managers' Index was 50.6, the same as November, which was a 7-month high. Scores above 50 indicate expansion, those below 50 contraction.

Africa is still making news for the wrong reasons. Besides Syria, Mali is now also in the media spotlight. French troops have deployed in Mali to assist in fighting an Islamist rebellion.

The world is little changed these past 3 months. Your manager remains focused on the search for investment value.

Your manager will write again when the report for the quarter ended 31 March 2013 is ready.

Benjamin Koh
Investment Manager
Lighthouse Advisors
23 January 2013

3. Portfolio Review

As at 31 December 2012, the Net Asset Value (NAV) of the Reference Account was $204.67 per unit, net of all fees. The highwater mark was $228.60. Against the end-2011 NAV of $186.42, the full-year return for 2012, net of all fees, was 9.8%.

Though the Account ended 2012 with gains, it remains below the highwater mark, and the return trailed major Asian indexes. As your manager does not *per se* invest in index component stocks, such "tracking error" is to be expected, even as long-term results, as measured since inception, continue to be satisfactory.

19 securities made up 88.4% of the Reference Account, with the balance in cash. A pie chart

[1] *China Again Is Growing, More Slowly*, **The New York Times**, 13 January 2013.

is in Annex I, while NAV values are tabled in Annex II.

As this is an annual review, in addition to divestments, new investments, and significant events, mistakes made and lessons learnt will also be discussed.

Divestments

There were no divestments for the quarter ended 31 December 2012.

New Investments

Greatview Aseptic Packaging manufactures roll-fed paper packaging for the liquid foods industry. In plain English, it makes packaging that is turned into milk containers. TetraPak is the dominant firm in the liquid packaging industry. Since starting commercial production in 1953, it has had a virtual monopoly. Today TetraPak's global market share is 80%, while its next largest competitor SIG has just 10%.

Although TetraPak is a private company, its continued dominance is *ipso facto* proof of high profitability. Many companies have tried – and failed – to copy its machines and packaging. Greatview's packaging works in TetraPak machines, making it an attractive second source for companies using TetraPak equipment. Greatview is now the second largest supplier of packaging for liquids in China. In 2009 its market share was 10%, significant but still far behind TetraPak's 70%.

There are three key reasons why Greatview succeeded. Their unlikely coincidence also points to the entry barrier for new competitors.

First, Greatview's senior managers in sales, engineering and plant management all came from TetraPak China. Their "senior converting advisor", a Swiss national, actually set up TetraPak's first plant in China back in 1985.

Second, Greatview was able to secure large amounts of funding. Two private equity firms, China Diamond Holdings and Bain Capital, provided a total of US$60m for expansion in 2005 and 2006 respectively.

Third, from 2003-2005 China experienced a boom in dairy consumption. TetraPak China was unable to keep up with domestic demand, which led to long lead times for delivery. Dairy companies were forced to look elsewhere for alternative packaging suppliers, which paved the way for Greatview's rise.

Today, private equity funding is still available in China, but technical expertise is hard to come by, and there is no longer an acute packaging shortage. Meanwhile, the underlying demand for milk continues to rise, and Greatview continues to take market share from TetraPak. It seems likely that Greatview will become much larger as it develops into an important second source for its customers.

At present, the largest dairy companies in China, Mengniu and Yili, get about 70% of their needs from TetraPak, and less than 20% from Greatview. The balance 10% comes from SIG. A 60/30 split would probably be more comfortable for Mengniu and Yili, which means a 50% increase in market share for Greatview. Greatview's overall market share in China today is about 14%, and they aim for 25-30% in 5 years' time. A <u>growing share of a growing pie</u> adds up to good news for long-term shareholders.

The shares were bought at about 15 times the trailing twelve months' earnings and 2.5 times book value. Forward dividend yield was 3%.

Other Significant Events

LMA International paid out a large advance distribution comprising over 95% of the proceeds from the sale to Teleflex. The shares have since been delisted from the SGX. There remains a small final distribution which will be paid out after the final liquidation.

k1 Ventures is close to realizing its investment in McMoRan Exploration (MMR). MMR has signed a definitive agreement with Freeport-McMoRan (FCX), whereby FCX will acquire MMR for a per-share consideration of US$14.75 in cash and 1.15 units of a royalty trust. The deal is subject to MMR shareholder approval as well as regulatory approval, and is expected to close in the second quarter of 2013.

Nera Telecommunications received another takeover offer. Eltek's 50.1% controlling stake was sold to Northstar, a private equity firm. The change of control triggered a mandatory general offer. Your manager judged the offer unattractive and did not accept.

Mistakes Made and Lessons Learnt

China Minzhong was a mistake as your manager ignored 3 warning signs at the point of investment: it was a fresh IPO with a limited track record, the managers were not the largest shareholders, and the business model consumes cash instead of generating it. The second quarter's newsletter discusses this in detail. Little more need be said except for the lesson: **pay attention to warning signs.**

Kingboard Laminates (KBL) was a mistake that was sold in the second quarter of 2012. Your manager forgot about it in that period's newsletter, so it will be discussed here.

In prior years, KBL's parent company Kingboard Chemical (KBC) had invested in commercial property. However its key subsidiaries KBL and Elec & Eltek had stuck to their respective competencies of producing printed circuit board laminates and printed circuit boards. Both paid substantial dividends to KBC which used this cash to service its debt and to invest in property.

The decision to invest in KBL was partly predicated on KBC's reliance on KBL's cash flows, as it meant that KBL's earnings would be largely monetized as dividends, to the benefit of minority shareholders.

However, your manager was caught off-guard when KBL directed its cash into buying land for residential development, instead of upstreaming most of its earnings to KBC. Evidently, the controlling Cheung family had decided that it was more efficient for KBL to use 100% of its cash to invest into real estate, than for KBC to invest its pro-rata 66% share of KBL's dividends.

This unhappy development drastically changed the investment picture for KBL minority shareholders, and your manager decided to sell. The loss on divestment was over 50%. The lesson: **past behaviour is no guarantee of future behaviour.**

4. Fair Value and Biological Assets

The adoption of "fair value accounting" has created an upheaval in financial markets. While the theoretical basis is sound, the rules are written generically and leave a great deal of room for judgment, so they have become open to abuse. There is a saying that "the road to hell is paved with good intentions".

Fair value accounting has sometimes been justified by pointing to cases where assets bought long ago had appreciated substantially in value, but were still carried on the balance sheet at historical cost. Fair value accounting would make clear the true market value of these assets. Ergo, fair value accounting was justified as a Good Thing™.

In fact, companies have always been free to disclose the fair market value of their assets. For example, **Haw Par** has a 4% stake in **UOB** which was previously carried at cost. Prior to adopting fair value accounting, it voluntarily disclosed the fair market value of its investments, which included the stake in UOB. In its 2004 annual report, Haw Par noted that long-term investments carried at $311m were in fact worth $766m at fair market value, and that short-term investments carried at $84m were worth $246m at fair market value.

But there are more insidious aspects of fair value accounting. Among them is the use of fair value accounting for "biological assets" i.e. crops, livestock etc. Fair value accounting allows companies to recognize changes in the "fair value" of their crops and livestock, rather than the actual cash received. This has led to ludicrous financial statements being produced. One particularly egregious example follows.

Oceanus is listed on the Singapore Exchange. It operates abalone farms in China, and at one time claimed to be the largest land-based producer, with over 20,000 tanks housing over 100 million abalones. In 2007 it reported sales of RMB 110m, but net profits of RMB 169m, thanks to RMB 227m of fair value gains. Excluding such fair value gains, Oceanus actually *lost* RMB 57m. This discrepancy widened each year, and by 2010 it reported RMB 132m in sales but RMB 580m in fair value gains. From 2008 to 2010 the company reported some RMB 2bn in fair value gains, against RMB 1.2bn of actual sales.

So where was the problem? There wasn't one, *assuming* that the abalones were eventually sold for fair value. But the basic assumption here is that the biological assets actually *existed*. On 9 November 2011 the company announced that 42 million abalones had been lost due to "high mortality". But importantly, ten days later the company also announced that "new mortality of abalones from now has to be matched by new empty shells". This meant that the shells of the 42 million dead abalones were <u>missing</u>, which begs the question of whether they existed to begin with.

A back-of-the-envelope calculation of the logistics involved in stealing 42 million abalones makes clear that traces would be left behind. If no trace of the abalones could be found, then they probably never existed at all. As for the remaining abalones, on 14 November 2011 it was revealed that 85.6 million were found to be laggards i.e. too small given their age. Their fair value had to be written down by over 50%.

How could 42 million abalones go missing and 85.6 million abalones turn out to be sub-par? One clue: the company revealed that its auditors, Deloitte & Touche, needed over 20 people and 3 weeks to complete a 5% audit. In other words, 95% of the tanks were *not* audited, so missing and undersized abalones went undetected for as long as 4 years. This eventually led to disaster. From a net profit of RMB 188m in 2010, the company reported a loss of RMB 1.2bn in 2011. Key items included a RMB 423m loss for changes in fair value, and another RMB 367m written off for the "dead" 42m abalones.

Who was to blame? One hint: the company sacked the CEO, stripped him of his role as legal representative and seized all the company seals from him.

So was Oceanus justified in recognizing fair value gains? Given that it lacked adequate controls to ensure its biological assets actually existed, clearly not. Even if it conducted 100% audits, the market price of abalones changes from time to time. Until the abalone is actually sold, its actual market value is unknown.

To be prudent, Oceanus should have reached an agreement with its auditors that fair value <u>could not be reliably determined</u>, and carried its biological assets at "cost less impairment". **Del Monte Pacific**, also listed on the Singapore Exchange, uses "cost less impairment" accounting for its pineapple plantations, with no complaints from its auditors KPMG. This, despite pineapple plants being easier to count (via aerial photography) and having a shorter lifecycle than abalones (18 months versus 5 years). So the use of fair value accounting by Oceanus definitely qualifies as being too aggressive – an assessment borne out by later developments.

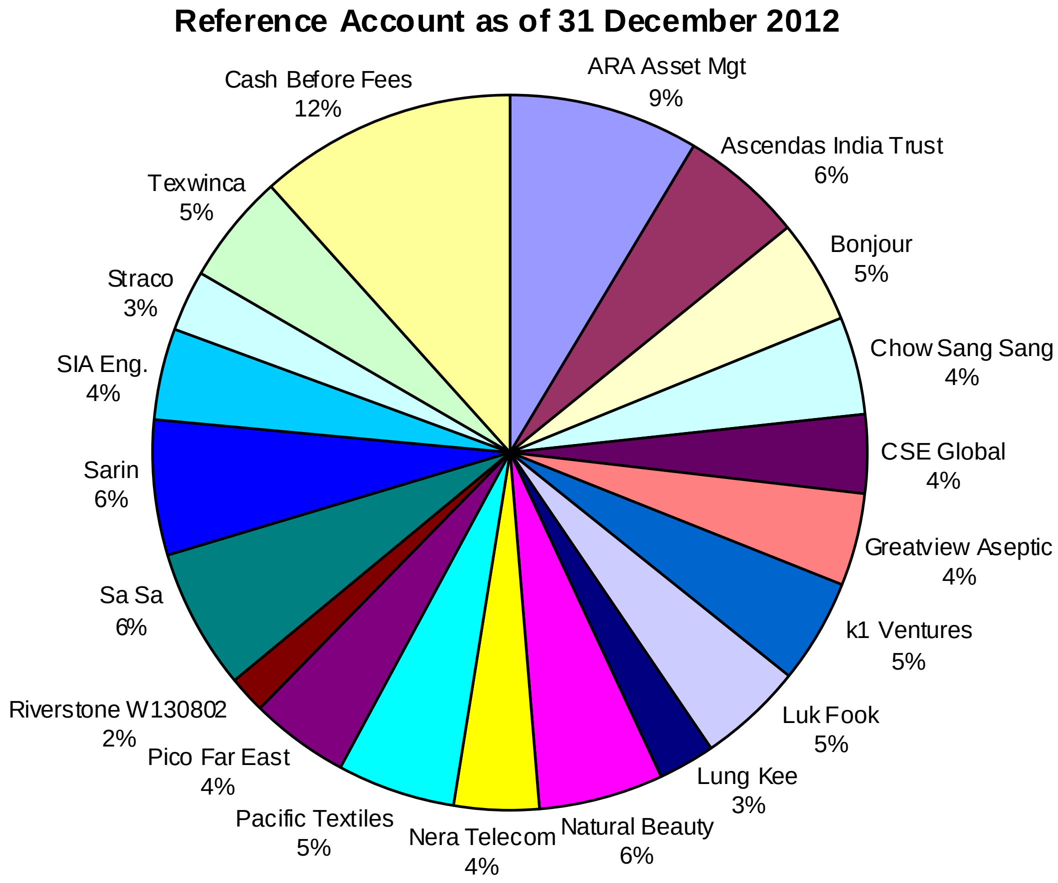
In an amazing show of common sense, the Hong Kong Exchange has <u>disallowed</u> the use of biological asset fair value gains when calculating profits for companies trying to go public. It is a great step in the right direction. If only other stock exchanges were as sensible.

End

LIGHTHOUSE ADVISORS

Keeping Your Capital Safe

Annex I



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%	191.28	88.43%
30 Nov	100.00	16.19%	154.88	87.41%	221.65	92.52%	184.76	83.96%	199.18	84.26%
31 Dec	101.02	52.56%	166.03	79.26%	228.60	85.71%	186.42	76.01%	204.67	88.35%
YTD	**+1.0%**		**+64.4%**		**+37.7%**		**-18.5%**		**+9.8%**	

Updated 23 January 2013