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 March 2013

1. **Foreword**
2. **Market Commentary**
3. **Portfolio Review**
4. **Withholding Taxes**

1. Foreword

Fellow Investors,

Welcome to the Lighthouse Advisors newsletter for March 2013.

Your manager is now a registered fund manager, subject to the new regulations set out by the Monetary Authority of Singapore. The fund continues to be a work in progress.

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

2. Market Commentary

The first quarter of the year has been marked by both new highs and new lows.

In the US, the Dow Jones Industrial Index and the S&P 500 have set all-time highs. Such optimism is pricing in an early recovery of the US economy. Unemployment is down to a 4-year low of 7.5% so it seems the recovery is indeed taking hold.

Across the Atlantic, European morale has reached a new low with the crisis in Cyprus. Like Iceland, Cyprus let its banks dominate the economy, to the point that banking assets were seven times GDP. Unfortunately, most of these assets were loans to Greece, so when Greece defaulted, Cyprus was hit hard. The Icelandic krona devalued more than 50% against the euro when its banks failed, and this depreciation has helped Iceland to recover. Cyprus uses the euro and had no such option.

Cyprus' bailout package was punitive: deposits up to the government guaranteed amount of €100,000 would be left intact, but amounts beyond this would suffer losses of up to 60%[1].

Ironically, the banking failure in Cyprus will make the strong stronger and the weak weaker. The likes of Deutsche Bank will be flooded with money fleeing the weak banks of the PIIGS countries. Deutsche Bank will likewise be among the few banks in a position to lend, which means that their net interest margins are likely to expand.

In Japan, the central bank's monetary easing has finally caused the yen to depreciate against the US dollar, with accompanying rallies in the Nikkei 225 index on expectations that exporters from Toyota to Panasonic will benefit from a weak yen. Eager investors have bought up every copy of the *Kaisha Shikiho*, the local guide to the Japanese stock market, suggesting the rally may have some legs[2].

In the "other bad news" section, North Korea has embarked on its annual saber-rattling exercise, with threats to turn Seoul into a "sea of fire". While the South Koreans have shrugged it off, the Chinese are losing their patience: Chinese President Xi Jinping issued a thinly-veiled warning that no country should be allowed to "throw a region and even the whole world into chaos for selfish gain"[3].

The remaining bad news is another avian flu outbreak in China, this time of the H7N9 strain. At last count there have been over 120

[1] *Calculating the Impact of Cyprus' Bailout*, **The New York Times**, 31 Mar 2013.

[2] *Bible of Japanese Equities Sells Out as Rally Wins Converts*, **Bloomberg News**, 14 Feb 2013.

[3] *China's Xi Warns Against Regional Chaos as Korea Tensions Rise*, **Bloomberg News**, 7 Apr 2013.

human cases, with 27 fatalities[4]. The Chinese poultry industry has predictably suffered enormous losses, the latest estimates are RMB 17 billion.

Your manager expects that the world will survive the H7N9 outbreak, the North Korea crisis, the European meltdown and so on. Stock market price declines will likely be opportunities to buy. Your manager remains focused on the search for investment value.

Your manager will write again when the report for the quarter ended 30 June 2013 is ready.

Benjamin Koh
Investment Manager
Lighthouse Advisors
13 May 2013

3. Portfolio Review

As at 31 March 2013, the Net Asset Value (NAV) of the Reference Account was $244.79 per unit, net of all fees, and above the highwater mark of $228.60. Against the end-2012 NAV of $204.67, the year-to-date return, net of all fees, was 19.6%.

19 securities made up 95.2% 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

Lung Kee (Bermuda) was sold as results deteriorated beyond expectations. Your manager underestimated the extent of the decline in the technology sector; the resilience of the automotive sector was not enough to offset the decline in the technology sector. Many of Lung Kee's customers manufacture technology components for export to the US and Europe, and the weak economy in these markets has affected Lung Kee's customers' volumes as well as their ability to pay Lung Kee a premium. As a result, Lung Kee was hit by both declining volumes and poorer pricing.

It seems investing in the technology sector requires specialized know-how that is currently beyond your manager. The shares were sold at a loss of about 25% after accounting for dividends received.

New Investments

Jaya Holdings owns 2 shipyards in Singapore and Batam, as well as a fleet of offshore support vessels chartered to third parties.

Founded in 1981 as a single-vessel company with one tugboat, Jaya was listed in 1992 with a focus on conventional shipping. By 1999 it had 2 yards in Singapore and Batam for shipbuilding and repair, plus a small fleet of container ships and some offshore support vessels.

In the early 2000s, Jaya anticipated that the global Anchor Handling Tug Supply (AHTS) vessel fleet would soon age and need replacements. It began a speculative newbuilding program using its own yards, plus partner yards in China. The move proved correct, and revenues and profits rose rapidly.

At the same time, the founders began to look for an exit. In 2004, they sold a 29.9% stake to Malaysian state-owned conglomerate Sime Darby, which sold the stake in 2007 to Affinity Asia, a private equity firm. Affinity subsequently raised its stake to 54.8%. One founder, Chan Mun Lye, was appointed CEO, while the others retired.

In 2009, the global financial crisis hit Jaya hard. Their customers could not get financing for their vessel purchases, while Jaya could not get financing for its newbuilding pipeline and supplier commitments.

Jaya began negotiating with its creditors, and in Jan 2010 a Scheme of Arrangement was agreed whereby principal repayments were deferred, but dividends were suspended. The suspension of dividends (and possibly a

[4] *China reports 27th death from H7N9 bird flu*, **Agence France-Presse**, 2 May 2013.

margin call due to the collapse of the share price) caused Affinity to default on the loan it had taken to buy its stake in Jaya.

Affinitiy's lenders seized the Jaya stake in Jan 2011. In Feb 2011, a consortium led by Deutsche Bank's distressed investment unit Cathay Asset Management bought the stake. In 2012, the consortium appointed new people to the board and senior management positions.

The company has now shifted its focus from shipbuilding to chartering. Three of the senior management, including the CEO, come from ship chartering backgrounds. The intent is to grow the charter fleet in order to generate a recurrent income stream.

Meanwhile, vessels in the newbuilding pipeline have been sold, and the proceeds used to pay down debt. In Dec 2012 the Scheme of Arrangement was terminated, and the company became free to pay dividends.

Although the AHTS vessels that Jaya builds and owns are commodities, equivalent to floating pickup trucks, the ageing of the global fleet is a real issue. As older ships are scrapped or cold-stacked for want of business, the new ships in Jaya's fleet will see increasing demand. As cash flows improve, Jaya will also be able to resume dividends. Indeed, shortly after your manager bought in, Jaya announced its Q2 FY13 results – and declared a small interim dividend.

As should be obvious by now, Jaya is another "special situation" investment. The consortium controlling Jaya is made up entirely of financial investors, so it is a given that Jaya will eventually be sold again. When that happens, it will be a good time for your manager to sell also. The shares were bought at less than 9 times historical earnings, and at about 0.85x book value.

4. Withholding Taxes

Usually, taxes are viewed negatively as they subtract from the profits attributable to shareholders, so the less taxes paid, the better. But sometimes, the presence or absence of taxes can be an important source of information.

Withholding taxes are a means of collecting tax. They are commonly used by countries to ensure that profits earned from within the countries are appropriately taxed when they leave the country. The taxes may apply on interest payments, royalties and even profits which have already been taxed. Generally, companies will try to structure their activities to reduce the withholding taxes payable. When such tax planning is taken to an extreme, however, investors should dig deeper.

For example, in June 2009, sports shoe company **361 Degrees** went public on the Hong Kong stock exchange. Since then it has reported cumulative profits of RMB 3.2 billion and paid out dividends of RMB 1.2 billion. All this sounds like great news: the company's profits are backed up by cash dividends, so everything must be good.

But the annual reports reveal a disturbing fact: **since IPO, the company has neither recognized nor paid any withholding taxes, despite paying out RMB 1.2 billion in cash dividends after going public**.

361 earns all of its profits in China, so it must upstream cash from its Chinese subsidiaries to the holding company to fund dividends to shareholders. As the holding company is domiciled in the Cayman Islands, remittance out of China attracts a 10% withholding tax on profits earned after 1 Jan 2008. As of 30 June 2008, 361 had retained profits of RMB 188m. Any money distributed in excess of this would attract withholding taxes.

361 has paid out RMB 1.2 billion since IPO. If RMB 188m came from pre-2008 earnings, that leaves over RMB 1 billion subject to withholding taxes. Yet, since June 2009, 361 has paid no withholding taxes, which means that at least RMB 1 billion of the cash it has paid out to date did not originate in China. Indeed, the holding company balance sheet

shows RMB 1.5 billion of cash on 30 June 2009, shortly after IPO. This was clearly money raised from the IPO. Another RMB 201m was raised in a placement in July 2009.

Clearly, most of the money paid to date has actually been a return of capital. Further evidence of this is that since July 2010, the Group has been charging the dividends solely against share premium instead of retained earnings. Coupled with the lack of withholding taxes, it means that of the RMB 1.7 billion in IPO money and placement proceeds, at least RMB 1 billion never made it into China, but was simply round-tripped from one group of investors to another via the holding company in the Cayman Islands.

From a flow-of-funds perspective this is very similar to a Ponzi scheme. The difference is that the bulk of the money was raised at one go in the IPO, and the later investors did not contribute capital, but bought out the interests of the initial IPO investors. But the effect is the same: minority investors have not participated in the profits of the business at all. As a group, their dividends were funded by their own capital and not the business itself.

A genuine Ponzi scheme will eventually collapse, but 361 has the option of actually taking cash out of its Chinese subsidiaries (and hence paying the withholding tax). **It appears, however, that 361 has no intention of ever doing so.** In April 2012 it issued US$150m of convertible bonds paying a 4.5% coupon, due in 2017. Part of this money has since been used to pay dividends. This makes no sense since 361 will end up paying a total of 22.5% in interest coupons, when it could upstream cash out of China, pay 10% in withholding tax and be done with it.

In 2017 the convertible bonds will need to be repaid, whether via cash remittance from China, thereby incurring the withholding tax anyway, or a fresh bond issue, which means yet more interest payments. If the management of 361 is unwilling to ever pay dividends from the underlying business in China, one might wonder whether the financial statements are accurate, since, if they are as "true and fair" as the auditors state, 361's Chinese subsidiaries should be more than able to pay dividends.

Comparisons to the Parmalat scandal are perhaps inevitable. Parmalat, an Italian food giant, was unmasked when it defaulted on a US$185m bond payment in November 2003, despite purportedly holding US$4.9 billion in a Bank of America account in the Cayman Islands. Soon after, Parmalat entered bankruptcy protection, and Bank of America reported that the US$4.9 billion account did not, in fact, exist.

Another issue relates to the "use of proceeds" as declared in the IPO prospectus, comprising HK$677m for brand development, HK$561m for production facilities, HK$157m to develop a children's sub-brand, HK$105m for a product testing and research and development laboratory, HK$68m for an enterprise resource planning system, and HK$174m for working capital and other corporate purposes.

Of the HK$1.7 billion (RMB 1.5 billion) raised in the offering, just 10% was allocated to working capital and other corporate purposes. But in fact we know that at least two-thirds of the proceeds were never used as planned, but were instead used to pay dividends to shareholders.

In other words, **money was raised for one purpose but was used for another.** Whether this constitutes securities fraud will be up to the authorities to decide. In theory, money is fungible, so it should be irrelevant whether 361 used its retained earnings in China or the IPO proceeds in the Cayman Islands to carry out its plans. But, as we have seen, in practice, because of withholding taxes, money is *not* fungible, and money in China is different from money in the Cayman Islands.

Based on its annual reports, 361 *did* actually carry out its plans, so it must have done so by using funds that were already in China and up to one-third of the IPO money. But the bulk of the money from the IPO was untouched and

used only to pay minority investors dividends out of their own capital. The promoters of course had the best deal: they retained full control of the operating companies in China, and they got paid dividends from the minority investors' money.

Of course, 361 is not alone in paying such "Ponzi dividends". Another Chinese shoe company listed on the Hong Kong stock exchange, China Dongxiang, is also guilty of paying dividends that exceed its pre-2008 retained earnings without also paying the accompanying withholding taxes.

Lest all the Chinese shoe companies be branded as miscreants, it should be noted that the annual reports of Li Ning, Anta, Xtep, and Peak Sport, which are all listed in Hong Kong, show that they have all recognized and paid withholding taxes, indicating that, for these 4 companies at least, dividends do seem to be funded by their Chinese subsidiaries.

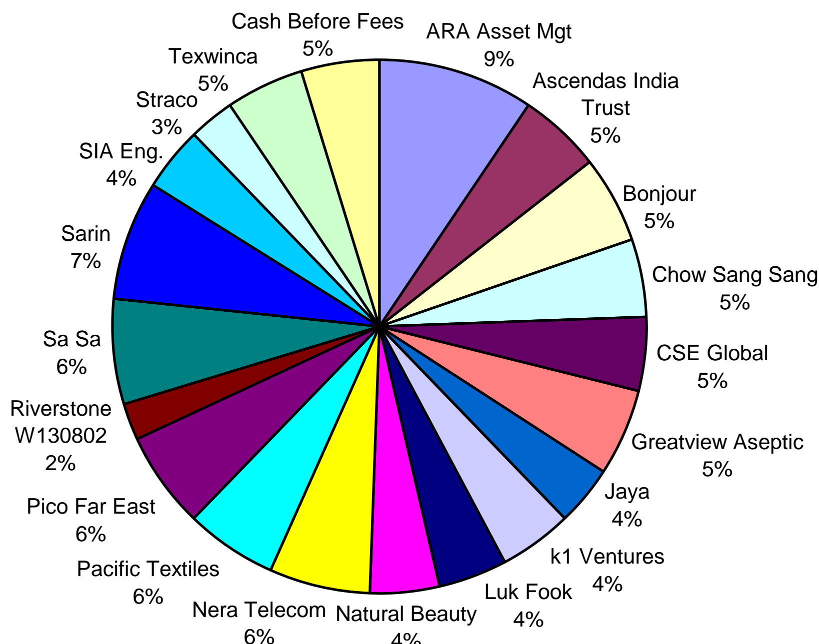
In conclusion, the payment of taxes is not necessarily a bad thing. Sometimes, they convey valuable information about what is happening, or not happening, inside a company.

End

LIGHTHOUSE ADVISORS

Keeping Your Capital Safe

Annex I



Annex II

2008	NAV ($)	Invested (Gross)
31 Jan		
28 Feb		
31 Mar		
30 Apr		
31 May		
30 Jun		
31 Jul		
31 Aug		
30 Sep		
31 Oct		
30 Nov	100.00	16.19%
31 Dec	101.02	52.56%
YTD		**+1.0%**

2009	NAV ($)	Invested (Gross)
31 Jan	103.03	52.48%
28 Feb	102.42	69.23%
31 Mar	100.11	51.25%
30 Apr	106.95	67.37%
31 May	131.61	73.01%
30 Jun	131.39	78.62%
31 Jul	142.18	80.00%
31 Aug	141.28	86.22%
30 Sep	146.38	88.44%
31 Oct	149.29	90.70%
30 Nov	154.88	87.41%
31 Dec	166.03	79.26%
YTD		**+64.4%**

2010	NAV ($)	Invested (Gross)
31 Jan	163.97	83.91%
28 Feb	169.35	93.00%
31 Mar	179.88	93.26%
30 Apr	184.58	90.31%
31 May	177.16	80.77%
30 Jun	180.97	84.17%
31 Jul	189.62	86.50%
31 Aug	193.05	92.43%
30 Sep	210.53	99.04%
31 Oct	213.32	95.13%
30 Nov	221.65	92.52%
31 Dec	228.60	85.71%
YTD		**+37.7%**

2011	NAV ($)	Invested (Gross)
31 Jan	220.13	86.53%
28 Feb	216.56	93.66%
31 Mar	219.13	85.79%
30 Apr	224.22	86.13%
31 May	221.20	87.01%
30 Jun	221.25	86.70%
31 Jul	216.53	83.65%
31 Aug	198.69	82.60%
30 Sep	177.28	84.05%
31 Oct	193.17	83.38%
30 Nov	184.76	83.96%
31 Dec	186.42	76.01%
YTD		**-18.5%**

2012	NAV ($)	Invested (Gross)
31 Jan	192.15	73.35%
28 Feb	204.12	79.44%
31 Mar	204.78	79.53%
30 Apr	203.33	84.41%
31 May	194.22	82.27%
30 Jun	192.88	81.41%
31 Jul	189.64	84.69%
31 Aug	191.78	86.68%
30 Sep	195.10	89.06%
31 Oct	191.28	88.43%
30 Nov	199.18	84.26%
31 Dec	204.67	88.35%
YTD		**+9.8%**

2013	NAV ($)	Invested (Gross)
31 Jan	223.32	95.63%
28 Feb	237.63	95.12%
31 Mar	244.72	95.24%
30 Apr		
31 May		
30 Jun		
31 Jul		
31 Aug		
30 Sep		
31 Oct		
30 Nov		
31 Dec		
YTD		**+19.6%**