Lighthouse Advisors Private Limited
(Reg. No. 201212773E)
54A Amoy Street
Singapore 069880
www.lighthouse-advisors.com

LIGHTHOUSE ADVISORS

Keeping Your Capital Safe

Client Newsletter for the period ended 30 June 2013

1. **Foreword**
2. **Market Commentary**
3. **Portfolio Review**
4. **Company-Issued Warrants**

1. Foreword

Fellow Investors,

Welcome to the Lighthouse Advisors newsletter for June 2013.

The Lighthouse Fund has finally launched! The original closing date was 31 July, but it has since been extended to 31 August.

Asset transfer issues are still being sorted out, so in-specie subscriptions are not yet possible. However the Fund is already able to accept cash subscriptions, in US Dollars, Hong Kong Dollars and Singapore Dollars. Lighthouse Advisors Private Limited has subscribed to the Fund, becoming the first client, as it should be.

As your manager's energy will now be focused on the Lighthouse Fund, this will be the last newsletter for the Reference Account. The Reference Account will no longer be actively managed. Instead, its assets will be transferred into the Fund as soon as practicable. Subsequent newsletters will focus on the Lighthouse Fund.

This newsletter follows the same format as previous issues. The special topic for this issue is **Company-Issued Warrants**.

2. Market Commentary

The second quarter of the year has given investors worldwide a timely reminder that stock markets are inherently volatile.

After strong gains in the first quarter, a comment in June by US Federal Reserve Chairman Ben Bernanke that the bond-buying program might be "tapered" led to sudden sell-offs, as short-term traders panicked that the flow of cheap money would soon dry up, reducing demand for stocks. Naturally this fed on itself, to the point that Bernanke had to issue a clarification that interests would remain low "for the foreseeable future"[1]. Markets have since had a "relief rally".

There is little new economic news to report. It is mostly business as usual. That is to say, the European recession continues, the US recovery continues, and the China slowdown continues. Japan remains an open question even as its stock market seems to have already assumed that "Abenomics" will succeed.

About the only "new" news is that Egypt has had a change of government – again. President Morsi came to power in democratic elections won by the Muslim Brotherhood, but failed to win over detractors as he sought to expand his powers. Discontent spilled over into the streets and eventually the army removed Mr Morsi. It remains to be seen what comes next for Egypt.

As with previous newsletters, your manager expects that "this too shall pass". Recent stock market declines in June were used to make some new investments. Your manager is optimistic that these will prove fruitful in the months and years to come.

The next report will be for the quarter ended 30 September 2013, and it will concern the portfolio of the Lighthouse Fund.

Benjamin Koh
Investment Manager
Lighthouse Advisors
4 August 2013

[1] *Bernanke Sees Very Stimulative Policy in Foreseeable Future*, **Bloomberg News**, 10 July 2013

Updated 4 August 2013

3. Portfolio Review

As at 30 June 2013, the Net Asset Value (NAV) of the Reference Account was $237.83 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 16.2%.

From inception on 1 November 2008 until 30 June 2013, the compounded annual return, net of fees, was 20.4%. The corresponding compounded annual returns for the 2 key markets in which the Reference Account was active, Singapore and Hong Kong, were 12.8% and 8.9% respectively. Your manager is no statistics expert, but believes this outperformance is credible evidence that our "conservative aggressive" investment approach has worked well for clients. In investment terminology, we have generated positive "alpha" so far.

21 securities made up 96.8% of the Reference Account, with the balance in cash. A pie chart is in Annex I, while NAV values are tabled in Annex II.

<u>Divestments</u>

Ascendas India was sold. It was the second stock purchased for the portfolio, back in November 2008. At that time it yielded over 15% and had a debt-to-equity ratio of just 6%. That offered an excellent margin of safety, together with good prospects for capital gains. The investment thesis was temporarily validated, as the stock subsequently appreciated 100% in the next 12 months.

However, the Indian government was unable to resolve India's current account deficit, leaving it dependent on foreign direct investment to balance the books. This proved untenable, and the rupee began a multi-year slide against other currencies, including the Singapore Dollar. As a result, internal gains in rupee terms made by the management were essentially offset by foreign exchange losses. Distributions in Singapore Dollar terms also declined, reducing the yield. In the end, the availability of more attractive opportunities drove the decision to divest. Including distributions received over the years, the gains on divestment were about 40%.

The lesson we received in this case is that macroeconomic headwinds can offset all the progress made by a company's management. As the original investment was made at a very attractive price, the final result was not poor, but selling out earlier, once the headwinds became apparent, would have had the beneficial twofold result of both better profits and earlier release of capital for other investments.

<u>New Investments</u>

CITIC Telecom has 2 main businesses. Firstly, it operates a telecommunications hub in Hong Kong connecting China to the outside world. It functions as the go-between for telecommunications companies worldwide who wish to connect to China. There are 2 fixed-line operators in China: China Unicom and China Telecom. Due to costs, most companies connect directly to only one of the two, and connect to the other indirectly via CITIC Telecom. Smaller companies connect only via CITIC Telecom.

As the volume of telecom traffic between China and the rest of the world is dependent on business conditions, the current muted economic conditions globally have resulted in less China-Europe and China-US traffic, which has depressed margins. However, as the world economy revives, traffic volumes and margins should also recover.

CITIC Telecom's second main business is *Companhia de Telecommunicadoes de Macau* (CTM). 99%-owned CTM is the incumbent telecom company in Macau. It was previously the monopoly provider of telecommunications and related services in Macau. The monopoly has since expired, but the small local market and high costs of entry mean that CTM continues to be the sole service provider in Macau. Like other tourist-heavy markets, CTM earns significant revenues from roaming charges. Macau has only 400,000 residents, but receives 28 million visitors a year, most of whom are price-insensitive gamblers. With its mature infrastructure, capital expenditure is minimal, and as the monopoly operator, pricing power is very strong. As a result, cash flow is excellent.

CTM was acquired only recently, but it has been working closely with CITIC Telecom for some time, and some of its key executives were in fact working at CITIC Telecom previously, so integration is not an issue. To buy CTM, CITIC Telecom raised money via a combination of bonds, a rights issue and bank debt. The acquisition has left the company with significant debt.

The focus for the next couple of years will be on paying down debt, but absolute per-share dividends will be maintained. The latest bank loan restricts the company from increasing dividends, but management has indicated that they will increase dividends once they have refinanced the loan.

The shares were bought at less than 8 times historical earnings, and at about 2.3 times book value. Dividend yield was about 4.5%.

Clear Media builds outdoor bus shelters in China in return for the advertising rights at these bus shelters. This concept of "street furniture" advertising was pioneered by the French company JCDecaux in 1964, and has since proven very successful worldwide. Globally, the dominant operators include JCDecaux, Clear Channel Outdoor, Lamar Advertising and CBS.

Clear Channel Outdoor operates in China via subsdiary Clear Media. Clear Media was created in 1998 as a joint venture between Clear Channel International from the US, and White Horse Advertising from Guangzhou.

Today, Clear Media is China's largest outdoor advertising company. It is dominant in its key markets of Beijing, Shanghai and Guangzhou, and it operates over 37,000 advertising panels across 28 cities.

As bus shelters require minimal capital investment, the underlying cash flow is strong. During expansion, this is masked by large payments to acquire advertising concessions from local governments. Indeed, after listing in 2001, the company invested heavily in more concessions, and cash flow was negative or only slightly positive for several years.

However, since 2007 the underlying cash flow has increased to the point that the company is now consistently free cash flow positive even after buying additional concessions. Debt has been completely paid off, and cash has begun to pile up. The company initiated dividends in 2011, and increased the payout in 2012.

The shares were bought at 15 times adjusted earnings, and just below book value. Forward dividend yield was about 3%. On a discounted cash flow basis, using conservative estimates, the purchase price was about 20% below the worst-case net present value, and about 1/3 less than the most-likely net present value.

Dynam Japan operates *pachinko* halls in Japan. Pachinko is a peculiarly Japanese form of entertainment, similar to a vertical pinball game, where small metal balls are launched upward and then cascade downwards through a maze of plastic channels. "Winnings" are paid in the form of more balls, which can be redeemed for prizes such as cigarettes or special tokens. The tokens can be sold to third-party buyers for cash, who in turn sell them back to the pachinko operators. Obviously, this is disguised gambling, but since there is supposedly a neutral third party between the player and the pachinko operator, everyone, including the government, pretends otherwise.

Japan's economy is widely considered to be in economic decline, which would mean headwinds for companies operating there. The pachinko industry is no different. However, declines provide opportunities to consolidate. Dynam is the second largest operator in Japan, but its market share is only 2.7%.

There is broad scope for expansion via acquisitions. Clear economies of scale exist in machine procurement and maintenance, as well as in advertising and marketing. Over time, Dynam Japan should increase its market share, its profitability and its cash flow. In the meantime, investors are being paid to wait.

The shares were purchased at about 7 times historical earnings and just under book value. Debt was just 4% of equity, and cash alone covered 98% of total liabilities. Dividend yield was about 4%.

Overseas Education operates the Overseas Family School (OFS) in Singapore. It caters to the children of expatriates working in Singapore. As a for-profit education business, it generates good cash flow, as little capital investment is needed beyond the initial campus construction.

For-profit schools face 2 key challenges: their fees are typically higher than those of not-for-profit schools, and as relative newcomers the quality of their teaching, and thus their reputation and pricing power, is unproven.

OFS positions itself as a "premier" school and charges accordingly. This attracts only parents who are both willing and able to pay a premium. Such parents are often well-educated, high-earning overachievers, who have equally ambitious goals for their offspring. Given the role that genetics plays in academic ability, highly educated parents often produce academically gifted children, who have good odds of doing well in school. The school thus starts with the best raw materials – bright pupils – in its quest for educational excellence.

Students at OFS take the International Baccalaureate (IB) examinations as their final preparation for university admission. The IB curriculum is recognized worldwide, so this sidesteps the issue of the school's reputation – results achieved by the students testify to the school's pedagogical success.

The situation that results is that the school charges a premium, thus attracting only parents whose children are already likely to do well, while their good exam results in turn allow the school to justify higher fees, some of which are reinvested into the staff and curriculum, and some of which can be returned to shareholders.

This virtuous cycle is not unlike how top universities worldwide continue their success: their reputations attract the best students, who are in turn more likely to perform well later in life, whether in academia, government service or private industry. The *alma maters* bask in the reflected glory – and proudly showcase their successful alumni during the next recruitment drive.

The shares were purchased at about 14 times historical earnings, and just under 3 times book value. Dividend yield was 4%. On a conservatively estimated discounted cash flow basis, the price paid was less than 50% of net present value.

Trinity is a luxury menswear retailer. Its key brands are *Kent & Curwen*, *Cerruti* and *Gieves & Hawkes*. It began as a licensee of these brands, selling them in China, and eventually bought the brands from the owners. Trinity is part of the Fung Group, which controls **Li & Fung**, one of the world's largest sourcing agents for garments and toys.

The key operating executives mostly come from the Fung Group and have many years of experience in their respective roles. Other executives, notably those in design and marketing, previously worked at other luxury brands such as *Ermenegildo Zegna*, *Brioni* (a brand under **Kering**, which also owns *Gucci*) and *Emilio Pucci* (an **LVMH** brand).

The current slowdown in China's domestic consumption is hurting Trinity, but with its strong brand positioning it should recover and do well over time.

The shares were purchased at about 10 times historic earnings and a trailing yield of 7%, but the forward outlook is uncertain given the poor economy. The management has already indicated that 2013 will be a "write-off" meaning that margins will decline, although they expect to stay nicely profitable. On a normalized basis, assuming margins return to industry norms, the price paid suggests 13 times earnings and a 5% yield.

Other Significant Events

Clear Media declared a large special dividend with their interim results announcement. The shares have appreciated considerably.

k1 Ventures has disposed of its investment in McMoRan Exploration (MMR). The proceeds were US$34.06m in cash and 2.66m units of a royalty trust.

4. Company-Issued Warrants

Company-issued warrants are warrants issued by companies which give the warrantholder the right, but not the obligation, to convert the warrants into common stock at a predetermined strike price. The warrants often have a relatively long life, sometimes as long as 2 or 3 years. They differ from third-party warrants issued by investment banks, which are usually settled in cash and have a short life, typically 3 to 6 months.

Since the warrants can be converted into common stock, they are dilutive. One might then ask why a company does not simply do a share placement or a rights issue if it needs money, instead of going through the complications of issuing warrants, which introduce uncertainties over their subscription.

One reason that has been offered by company management is that warrants delay dilution until such time that they are actually exercised. Share placements and rights issues raise the full sum at one go and thus cause immediate dilution. But since investors generally take outstanding warrants into account, it is unclear why management would think that delaying the inevitable is helpful. Nonetheless, the delayed dilution continues to be proffered as an explanation.

Another reason that has been offered up is that the warrants are a "reward" to shareholders for their loyalty. This reason is sometimes given when a company is strapped for cash and unable to increase dividends, or is unable to even pay a dividend in the first place. Because of the fixed strike price and long life, warrants are effectively long-lived call options. This makes them very attractive vehicles for speculation, since for a limited outlay the speculator may lay claim to enormous fortunes should the underlying stock rise in value. As such, some managements view the issue of warrants as a "gift" to shareholders. It is twisted logic indeed that an instrument that consumes cash could possibly be considered a worthy substitute for a cash dividend.

Even so, the speculative value of the warrant is not free. The cost is that the common stock now becomes *un*attractive to speculators, which depresses its price. Logically speaking, the total market value of a company's common stock, plus the market value of all outstanding warrants, cannot be more than the market value of the same company if it had no outstanding warrants, for otherwise every company could immediately become more valuable by simply issuing said warrants. So the market value of warrants is actually "stolen" from the common stock.

If a company issues warrants pro-rata to its shareholders, whether as part of a rights issue or a bonus issue, the shareholders are no worse off: losses on the common stock are offset by expected gains on the warrant. Shareholders can subsequently choose to increase or decrease their holdings of warrants, and thus choose their risk/reward balance. This in turn allows outside investors to buy only the warrants, limiting their downside risk but participating in most of the upside. In fact your manager previously invested in the warrants issued by Goodpack and Riverstone. Both cases were ultimately unprofitable, but the limited cash outlays served their purpose in reducing the capital that was put at risk.

Sometimes, however, warrants are *not* issued pro-rata. In such cases it is usually a *quid pro quo*: an investor is induced to subscribe for bonds at a below-market interest rate, in exchange for receiving warrants with a long life and an attractive strike price. Note that if the warrants cannot be detached from the bonds, the bond-warrant combination takes the familiar form of a convertible bond. This can be a fair deal for all parties involved, where the company borrows money at a below-market rate at risk of future dilution, while the new investor sacrifices a market rate of interest on the bonds for the possibility of capital gains through the warrants.

Unfortunately, warrants may also be issued to specific parties *without* corresponding benefits for the company. There should be a special place in stock market purgatory reserved for such issuers. This type of transaction clearly transfers value away from existing shareholders to the new warrantholder. Shareholders are stuck with the now-unattractive common stock, while the new warrantholder only holds the warrants, which have attractive speculative characteristics. To make things worse, the warrants are often issued for *de minimis* consideration, which further amplifies the potential gains for the new investor.

One such company which "warrants" an entry in the Hall of Shame is **Chu Kong Shipping**. In May 2013, it placed out 180m unlisted warrants at the price of just HKD 0.01 per warrant. The strike price was at a 15% premium to the prevailing market price, and the warrants would expire after 1 year. The warrants represented 20% of the existing share capital of the company, a significant dilution.

The terms were clearly attractive to the warrants' buyers. For a paltry sum of money, they purchased call options with a long life and a modest strike price premium. Conversely, the terms were awful for the company and its existing shareholders. In exchange for the risk of significant dilution at a modest premium, the company received only HKD 1.8m, a token sum of money which was completely immaterial to its existing cash hoard of HKD 585m as of 31 Dec 2012.

That these warrants were not offered pro-rata to shareholders via a bonus or rights issue is a travesty and deeply offensive to the concepts of corporate governance and shareholder value. If the stock declines, shareholders suffer, but warrantholders only lose their option premium of HKD 1.8m. If the stock soars, as much as one-sixth of the capital gains will go to warrantholders, whose profit will then be many times their initial cash outlay. Crudely put, warrantholders can hardly lose, while shareholders can hardly win. Hapless shareholders invested in such companies would do well to consider whether their funds could be better invested elsewhere.

End

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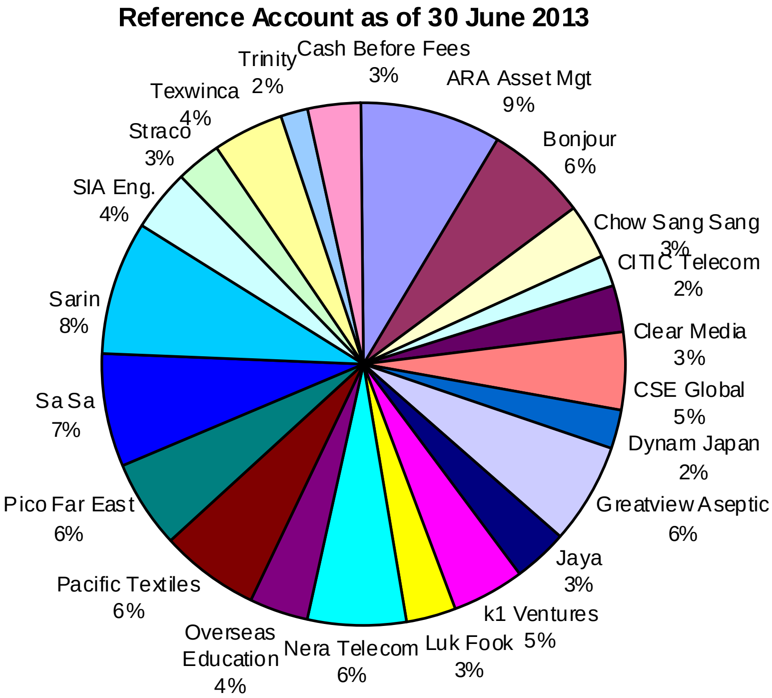
Annex I



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	243.67	90.83%
31 May	247.30	95.19%
30 Jun	237.83	96.75%
31 Jul		
31 Aug		
30 Sep		
31 Oct		
30 Nov		
31 Dec		
YTD		**+16.2%**