LIGHTHOUSE ADVISORS
Keeping Your Capital Safe

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Client Newsletter for the period ended 31 December 2013

1. Foreword

Fellow Investors,

Welcome to the Lighthouse Advisors newsletter for December 2013.

The Lighthouse Fund is finally up and running! This is the first newsletter concerning the Fund.

For the benefit of new investors, all of the Fund's holdings will be briefly discussed. Subsequent newsletters will only discuss new investments, divestments and significant corporate events.

Your manager wishes everyone a Happy Lunar New Year.

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

2. Market Commentary

Major stock markets ended 2013 with solid gains amidst economic uncertainty.

Cost cuts and increased consumer spending boosted corporate profits in the US. At the same time, European markets were heavily oversold after several consecutive years of bad news, which sparked a rebound. Developed markets generally did well, as shown below.

Market	2013
US DJIA	+26.5%
US S&P 500	+29.6%
UK FTSE 100	+14.4%
Europe Stoxx 50	+17.9%
ASX 200	+16.7%
Nikkei 225	+56.7%

The top performing developed market was in Asia. Japan's Nikkei 225 soared as investors bet on Prime Minister Shinzo Abe's economic stimulus to arrest deflation and spur recovery.

In emerging Asian markets, full-year returns were less uniformly positive:

Market	2013
Shanghai Composite	-6.8%
Hang Seng Index	+2.9%
India Nifty Index	+6.8%
Jakarta Composite	-1.0%
Thailand SET	-6.7%
Philippines PSEi	+1.0%
Malaysia KLCI	+10.5%
Singapore STI	+0.0%

Shanghai was weighed down by fears of a slowdown, while in Thailand, widespread demonstrations (both for *and* against the government) spooked foreign investors. These two markets will likely prove interesting to those willing to look beyond first impressions.

Your manager is becoming interested in Thailand, but given the political complexities, patience is essential. Jeffrey Race, a political analyst based in Thailand for the last 45 years, points out that the problem is not abuse of power *per se* by the Shinawatra clan, but its sheer extent and duration[1]. This is complicated by the fact that some of Thaksin's policies *did* actually improve the lot of the rural poor, so they voted for him at the ballot box. In Mr Race's view, any long-lasting solution must address both the Shinawatras' departure and rural development.

As we enter the Year of the Wood Horse, stock markets worldwide have again been spooked by the US Federal Reserve's tapering of its bond-buying activities. Coupled with

[1] *History shows way out of Thai conflict*, **Asia Times**, 13 Jan 2014.

Updated 24 February 2014

data showing that China's official Purchasing Managers Index dropped to a 6-month low in January, stock markets have begun selling off again[2].

As is often the case, momentum chasers have abandoned yesterday's favorite, and last year's top dog Japan is currently the worst-performing developed market, with the Nikkei 225 down 13% year-to-date as of market close on 6 February. Emerging markets have also suffered outflows, along with currency declines, most obviously seen in India, Indonesia, South Africa, Turkey and Brazil, who have been unflatteringly dubbed the "Fragile Five" on account of shared woes such as fiscal and current account deficits, falling growth rates, above-target inflation and current-year political uncertainty.

Your manager considers such fears with regards to Asia to be overblown, and is buying selectively as prices decline. If prices continue to fall, value will become more widespread, making investing easier, but fundraising harder. This is the strange irony of the fund management business, where one can raise money and make money – but not usually both at the same time. In any case, your manager has invested more money into the Fund.

The next newsletter will be published for the quarter ended 31 March 2014.

Benjamin Koh
Investment Manager
Lighthouse Advisors
7 February 2014

3. Portfolio Review

As at 31 December 2013, the Net Asset Value (NAV) of the Fund was USD 102.93. Net of all fees, the year-to-date return since inception in September 2013 was +2.9%.

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[2] *Asia stocks fall on China PMI; Nikkei closes at 2-1/2 month low*, **CNBC**, 3 Feb 2014.

20 securities made up 55% of the Fund's holdings, with the balance in cash. A pie chart is in Annex I, while NAV values are tabled in Annex II.

Your manager has received enquiries regarding portfolio aggregate valuations using metrics such as price-to-earnings, price-to-book etc. In the context of the fund's holdings, such aggregate ratios are not particularly meaningful because the fund's portfolio holds 3 distinct types of investments:

"Good Businesses" which show superior rates of return and growth, and often trade at apparently high multiples of earnings and book value;

"Cheap Stocks" which are usually so-so businesses with moderate prospects, trading at modest valuations; and

"Special Situations" where historic earnings and book values mean very little in the face of ongoing or upcoming corporate activities.

Given the disparate nature of the investments, they will be discussed group-by-group.

Summary of Investments

Good Businesses

ARA Asset Management is a manager of real estate-focused funds. Its total assets under management (AUM) were SGD 23 billion on 30 Sep 2013, three quarters of it in real estate investment trusts (REITs) and the balance in private funds. The fund management business has excellent economics due to good scalability and low capital requirements.

In prior years, the company grew its AUM by having its REITs acquire properties from Hong Kong tycoon Li Ka-Shing's **Cheung Kong** conglomerate. Of course, that pipeline will not last forever. However, a second pipeline has been created with the entry of Singapore-based **Straits Trading** as a new strategic investor. In October 2013, Straits acquired a 20.1% stake from founding shareholders John Lim and Cheung Kong and became the single largest shareholder of ARA.

It is a win-win situation as Straits will provide its existing SGD 830m real estate portfolio to ARA to manage and will set up a SGD 950m co-investment vehicle with John Lim to seed new funds to be managed by ARA. This should extend the growth horizon for ARA by several more years. In return, Straits gains a new channel through which it can divest its real estate assets at attractive prices by selling them to REITs managed by ARA.

Since going public in 2007. ARA's return on equity has averaged 37%. Return on assets has averaged 29% over the same period. This is likely to continue given the annuity-type nature of its REIT management fees, with occasional boosts from profit-sharing arrangements at the private funds.

Debt is modest at 9% of shareholders' equity, and cash on hand exceeds all debt.

The shares currently trade at about 20 times earnings with a dividend yield of 3%.

Bonjour is Hong Kong's second-largest cosmetics and skincare retailer, with over 40 *Bonjour* stores. It has a secondary business in beauty salons under the *About Beauty* brand.

Bonjour operates primarily in Hong Kong with a few stores in Guangzhou, China. Almost half of the Group's retail sales come from mainland Chinese shoppers. Bonjour sells some 20,000 different products, many of which are discounted parallel imports which serve to draw in customers, who can then be cross-sold the more profitable private-label and exclusively-distributed products.

Retail rents in Hong Kong have soared in recent years, but the Group has kept pace by actively managing the store network. "Disneyland fever" in 2005 saw it expand aggressively, expecting crowds which did not materialize, resulting in losses. Since then, the Group has been more careful with store leases.

As a retailer, it buys from suppliers on credit, but sells to customers for cash, so cash flow is strong. With capital expenditure limited to simple store fit-outs, most of the accounting earnings convert into free cash flow. Most employees are sales staff with wages tied to performance, so wage inflation is less of an issue. Store inventory has a long life, typically 2 years or more, minimizing pressure to clear unsold stocks. Finally, cosmetics and skincare products carry very high gross margins, allowing Bonjour to make a decent profit when all is said and done.

Since IPO in 2003, Bonjour's return on equity has averaged 47%. Return on assets has averaged 16% over the same period.

Debt is just 7% of equity, and cash on hand exceeds all debt.

The shares trade at about 18 times the last 12 months' earnings, with a yield of about 5%.

Chow Sang Sang is one of Hong Kong's three major jewellery retailers. It operates 366 stores across greater China: 59 in Hong Kong, 14 in Taiwan and 286 in mainland China. In recent years, sales growth has come from the increased number of mainland Chinese visitors to Hong Kong.

China's value-added tax and luxury tax add up quickly for big-ticket items, such that well-off Chinese can fly into Hong Kong for a weekend of dining and shopping: even after paying for the air ticket and staying in a luxury hotel, they *still* save money over buying the same products in China.

Gold holds a particular allure for the Chinese (and Indians, but that is another story). When gold prices fell in 2013, Chow Sang Sang experienced a "gold rush" which boosted retail sales significantly. Gold items attract lower gross margins than gem-set jewellery, but the higher volumes generate good absolute profits.

The ascendance of the Chinese consumer has fueled Chow Sang Sang's rise. In the last 7 years, return on equity averaged 14%, while return on assets has averaged 10%. In the same period, earnings per share compounded at 20% per year, while book value per share compounded at 16%.

Debt stands at 23% of equity, but cash on hand covers more than two-thirds of the debt.

The shares trade at 12 times the last 12 months' earnings, with a yield of 3%.

Greatview Aseptic Packaging manufactures roll-fed paper packaging that is turned into milk containers.

Swedish company **TetraPak** dominates the liquid packaging industry. Since commercial production began in 1953, it has had a virtual monopoly. Today TetraPak's global market share is about 80%, while its next largest competitor SIG has just 10%.

Over the years, many companies have tried and failed to copy TetraPak's machines and the packaging they use. Greatview has managed to make packaging that works in TetraPak machines, making it an attractive second source for companies which have already installed TetraPak equipment i.e. virtually everyone in the milk industry. Greatview is now the second largest supplier of packaging for liquids in China, behind only TetraPak.

There are four key reasons why Greatview succeeded. Their unlikely coincidence also outlines the high entry barriers for new would-be competitors.

First, Greatview's senior managers in sales, engineering and plant management all came from TetraPak China. In fact, 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, creating long lead times for delivery. Dairy companies were forced to use alternative suppliers, paving the way for Greatview's rise.

Fourth, in 2007 China issued a landmark antimonopoly law. This made it illegal for dominant companies like TetraPak to use bundled sales or exclusive supply contracts to lock in customers and increase profits. TetraPak's customers thus became free to buy packaging material from other suppliers. Greatview was among the beneficiaries of this flood of new business.

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, nor a sudden rush of new business released from restrictive contracts. Meanwhile, the underlying demand for milk continues to rise, and Greatview continues to take market share from TetraPak. It seems highly likely that Greatview will become much larger as it develops into an important second source for its customers.

At present, the two 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% is from SIG. A 60/30 split would likely be more comfortable for Mengniu and Yili, which means a 50% increase in sales to these 2 key customers for Greatview. Its overall market share in China today is about 15%, and management aims for 25-30% in 5 years' time. A growing share of a growing pie is good news for long-term shareholders.

Return on equity has averaged 17% in the last 7 years. Return on assets averaged 13%.

Debt is 10% of equity, and cash on hand exceeds all debt.

The shares trade at about 17 times the trailing twelve months' earnings and 2.4 times book value. Forward dividend yield is 3%.

Luk Fook is a Hong Kong-based jewellery retailer and distributor. It operates 44 stores in Hong Kong, 10 in Macau and 82 in mainland China. In addition, there are 1,112 licensee stores in mainland China. As with key rival Chow Sang Sang, more than half the sales in Hong Kong come from Chinese tourists. As Chinese tourist arrivals in Hong Kong increase, their relative importance will continue to rise.

Like key rival Chow Sang Sang, the company has been riding the wave of Chinese visitors to Hong Kong. In the last 7 years, sales grew at a compounded rate of 29% per year, while profits rose at 36% per year. Earnings per share compounded at 32% annually, and book value per share compounded at 36%. Return on equity averaged 25%, and return on assets averaged 18%.

The Group is debt-free, and cash on hand exceeds all liabilities.

The stock trades at 9 times the trailing 12 months' earnings and yields 4%.

Nera Telecommunication is a provider of telecommunications solutions. Its main market segments include wireless network infrastructure and electronic payment solutions. As a services company, capital expenditure is limited, so cash flow is strong.

It was originally a special situation investment for the managed accounts. The shares were acquired when the company was put up for sale at too cheap a price. It has since been sold to a private equity fund and is now "merely" a good business.

Return on equity has averaged 19% in the last 7 years. Return on assets averaged 10%.

The Group is debt-free and cash on hand exceeds all liabilities.

The shares trade at about 16 times trailing earnings, at a yield of 6%.

Overseas Education operates the Overseas Family School (OFS) in Singapore. It caters to the children of expatriates working in Singapore. The students take the International Baccalaureate (IB) examinations as their final preparation for university admission.

As with most service businesses, capital investment is limited beyond the initial campus construction, so cash flow is strong.

Schools can raise tuition fees in line with inflation, as wages form the bulk of cash costs. However, non-wage costs do not inflate at the same rate. Depreciation is fixed after the initial campus construction, and increases only modestly with maintenance. Given the rate of advancement in information technology, technology investments cost less and less per cycle of computing power. Therefore, overall operating margins will expand over time as revenues increase faster than costs.

The new campus in Pasir Ris will enroll approximately 4,800 students versus its current enrollment of 3,800. This means that when the new campus opens in 2016, revenues will receive another boost.

Return on equity has averaged 43% in the last 7 years. Return on assets averaged 17%.

The Group is debt-free, but will likely take on some debt to fund its new campus.

The shares trade at about 15 times trailing earnings and yield 3%. On a conservatively estimated discounted cash flow basis, the stock trades at about 55% of net present value.

Pacific Textiles manufactures high-end fabric. It buys yarn and converts it into fabric, while dyeing or printing it. *Uniqlo* is the company's single largest end-customer brand, forming about 40% of sales. For complex fabric such as lingerie, *Triumph* and *Victoria's Secret* are among its end-customer brands.

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 current executive directors were also executive directors there, while chairman emeritus Choi Kin Chung was a co-founder and former vice chairman of Fountain Set.

Unlike many of its textile-making peers, the Group is very strict about inventory control. As a result, when cotton prices spiked and then crashed in 2011, the company avoided the inventory-based gains (and later, losses) booked by its peers who had hoarded cotton in anticipation of continued price increases.

Return on equity averaged 24% in the last 10 years. Return on assets averaged 15% over the same period.

Debt is just 1% of equity, and cash on hand exceeds all liabilities.

The company's shares trade at about 16 times the trailing 12 months' earnings and yield 7%.

Sa Sa International is a multi-label cosmetics retailer and distributor. From a 40 square foot counter in a basement in 1978, founders Eleanor and Simon Kwok built Sa Sa into Hong Kong's largest cosmetics retail chain.

Sa Sa and archrival Bonjour use a similar approach: use low-priced parallel imports to draw customers, then convert them to more profitable private-label and exclusively-distributed products. Sa Sa sells mid-high end products, while Bonjour is mass-market.

Return on equity averaged 23% in the last 13 years, while return on assets averaged 17%.

The Group is debt-free and cash on hand exceeds all liabilities.

The stock trades at about 25 times trailing earnings, at a dividend yield of 3%.

Sarine Technologies (formerly Sarin Technologies) makes equipment for mapping rough diamonds. Imperfections, "inclusions" in industry parlance, reduce a diamond's value. The maps help diamond manufacturers plan the cutting and polishing to minimize or avoid inclusions in the final stones. Sarine is the market leader: its products are used by most major diamond manufacturers and all the major gemological institutes worldwide.

The company's current star product, the *Galaxy* line of mapping systems, is offered primarily as a pay-per-use service. Recurring revenues now form about 1/3 of total sales.

The shares were originally purchased in the second quarter of 2010 for the managed accounts as a special situation investment. At that time, co-founder Uzi Levami had just rejoined the company and the *Galaxy* products were only beginning to contribute to revenues. The company is no longer a poorly understood and mispriced turnaround situation, but is "merely" a good – if not excellent – business.

Return on equity has averaged 25% in the last 7 years, while return on assets averaged 20%.

The Group is debt-free, and cash on hand exceeds all liabilities.

The stock trades at about 30 times trailing earnings and yields 2%.

Straco owns and operates tourist attractions in China. Its key assets are the Shanghai Ocean Aquarium and Xiamen Underwater World. Minor assets include a cable car operation in Xian and a joint venture cabaret show.

"Tourism infrastructure" assets like aquariums have a remarkable ability to generate cash. Many such entities are *not* profitable, however, because they are structured as not-for-profit operations, and spend most of their revenues on public education, as it would be politically unwise to book large profits. Commercial operators are not bound by such considerations, and by pruning such spending appropriately, they can capture a great deal of the savings as profits and distributable cash.

The cash flow of such assets is not a secret: the Merlin Entertainments Group has been buying up tourism attractions worldwide, including Living and Leisure Australia (LLA), Asia's largest operator of aquariums. LLA owns aquariums in South Korea (Busan), Thailand (Bangkok), China (Shanghai), and Australia (Melbourne and Sunshine Coast).

LLA's Shanghai Chang Feng Ocean World is in the outskirts of Shanghai and not near any subway stations or other tourist attractions. It is therefore not a strong competitor to the Shanghai Ocean Aquarium.

For Merlin, buying the Shanghai Ocean Aquarium, or even all of Straco, would make strategic sense. However, as Straco is not in any financial distress whatsoever, shareholders have the luxury of waiting for Merlin or some other buyer to pay up. In the meantime, the aquariums continue to bring in the crowds – and the cash.

Also, Straco has recently put in a bid for a project. If it succeeds, this should be a significant acquisition that can meaningfully improve earnings.

The Group is debt-free, and cash on hand exceeds all liabilities.

The stock trades at 12 times trailing earnings and yields 3%.

Cheap Stocks

CITIC Telecom has 2 main businesses. Its first business is a telecommunications hub in Hong Kong connecting China to the outside world. There are 2 fixed-line operators in China: China Unicom and China Telecom. Due to costs, most overseas telcos connect directly to only one of them, and connect to the other via CITIC Telecom. Smaller telcos connect only via CITIC Telecom.

The volume of telecom traffic between China and the rest of the world is currently depressed due to muted economic conditions globally. However, as the world economy revives, volumes and margins should 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 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. The deal was funded via a combination of bonds, a rights issue and bank debt. It 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 has covenants that restrict the company from increasing dividends, but management has indicated that they will increase dividends once they have refinanced the loan.

The pro-forma data for the combined company indicates that under normal economic conditions, return on equity will exceed 30%, while return on assets will be about 13%.

Debt is about 4x EBITDA.

The shares trade at about 8 times EV/EBITDA and yield 4%.

Clear Media builds outdoor bus shelters in China in return for advertising rights at these shelters. "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 its 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 dominates its key markets of Beijing, Shanghai and Guangzhou, and operates over 38,000 advertising panels across 27 cities.

Bus shelters are fairly basic structures, so capital investment is minimal. During expansion, the underlying cash flow 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 is piling up. The company initiated dividends in 2011 and increased the payout in 2012. In 2013 it also paid a large special dividend.

Return on equity has averaged 6% in the last 13 years, while return on assets has averaged 4%. These numbers appear unimpressive at first glance but are distorted by very large non-cash charges due to amortization of the concessions. EBITDA return on assets has averaged 13% in the same period.

The Group is debt-free, and cash exceeds all liabilities.

Because of the distortions caused by the amortization charges and the large cash balance, the cash flow is a more useful metric for valuation, and on this basis the shares trade at 4.4x EV/EBITDA. They yield 2%. On a discounted cash flow basis, using conservative estimates, the stock trades below the worst-case net present value, and about 25% below the most-likely net present value.

CSE Global is an engineering services company specializing in automation for the oil and gas industry. It is a global business spread across the Americas, the 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 government-owned 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. Most of these deals have been successful. Annual revenue now exceeds $450m, compared to $100m just after IPO. Profits in recent years have crossed the $40m mark, against just $14m in 2000.

In the last 10 years, return on equity averaged 27%, while return on assets averaged 11%.

Following the divestment of its UK-based businesses and the use of some of the proceeds to repay debt, the Group is currently debt free.

After payment of a special dividend, the shares now trade at about 10 times adjusted earnings. Expected yield is 4%.

Dynam Japan operates *pachinko* halls in Japan. Pachinko is a type of vertical pinball game specific to Japan, where small metal balls are launched upward, 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. These tokens are sold to third-party buyers for cash, who in turn sell them back to the pachinko operators. This is disguised gambling, but as there is officially a neutral third party between the player and the pachinko operator, everyone, including the government, pretends otherwise.

The pachinko industry is mature but fragmented, which provides opportunities to consolidate. Dynam is the second largest operator in Japan, but its market share is only 2.7%. 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.

Return on equity has averaged 21% in the last 4 years. Return on assets has averaged 11%.

Debt to equity is 4%, and cash on hand exceeds all liabilities.

The shares trade at about 14 times trailing earnings and slightly over 2 times book value, and yield about 4%.

Pico Far East is the world's largest exhibition services company. It has 2,500 staff across 35 cities worldwide. The founding Chia family is still heavily involved in the management, and the second generation of the family is already working at the company. One of them, Jean Chia, became managing director in 2008.

Pico's main business is the design and manufacture of booths used at meetings, incentives, conventions and exhibitions (MICE). It is involved in virtually every global event, including the World Expo and the Olympics. Pico also makes outdoor signage for petrol stations, automotive dealerships and fast-food restaurants.

Delivering such products on a large scale requires significant capital investment into a factory. Pico made this outlay long ago in Hong Kong, Singapore, Thailand and Malaysia, and recently opened plants in Shanghai and Beijing.

Rivals are far smaller and are mainly designers striking out on their own. Some are actually ex-Pico staff. However, these firms quickly find out that designing an exhibit stand is one thing, but manufacturing 100 of them on time and within budget, using a factory they don't own, for delivery and installation within a 2-day window, is quite another. And for one-off custom exhibits for multinational companies, it is far simpler to give a global contract to Pico, than to negotiate individual deals with local operators in different cities.

The main market is Greater China, accounting for 62% of revenues. From any sensible viewpoint, it seems likely that China's share of the world's MICE events will continue to grow, and Pico with it.

FY13 earnings were depressed due to a lack of mega-events such as the World Expo and Olympics. They should pick up again in 2014 with the Winter Olympics in Sochi, Russia. The shares trade at 10 times forward earnings and 1.8 times book value, and yield 4%.

Texwinca is 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, and thus the lowest-cost producer. Although it produces in large volumes, Texwinca actually makes most of its money from "rush" orders, when customers pay more for quick delivery.

Management estimates 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 increased market share and further economies of scale.

Texwinca also owns the *Baleno* brand of apparel. It is run independently of the manufacturing arm, and sources about 25% of its apparel needs from it. Baleno is currently facing some tough times in China given the slowdown in consumer spending.

Return on equity has averaged 21% in the last 13 years. Return on assets has averaged 12%.

Debt is one-third of equity, but cash on hand exceeds all liabilities.

The shares trade at 12 times the trailing 12 months' earnings and about 1.7 times book value. Dividend yield is 7%.

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.

Since IPO in 2009, adjusted return on equity has averaged 14%, while return on assets has averaged 9%.

Debt is 35% of equity, but is 99% covered by cash on hand.

The shares trade at about 11 times trailing earnings and yield 8%, but the management has already indicated that 2013 will be a "write-off" meaning that margins will decline, although they expect to stay nicely profitable. Assuming margins eventually return to industry norms, the shares sell at 8 times normalized earnings and will yield 11%.

Special Situations

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

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 rocketed as its vessels were snapped up.

In 2004, the founders sold a 29.9% stake to Malaysian state-owned conglomerate Sime Darby, which on-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 negotiated with its creditors, and in January 2010 a Scheme of Arrangement was agreed whereby principal repayments were deferred, but dividends were suspended. The suspension of dividends (and possibly a 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 January 2011. In February 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 are being sold, and the proceeds used to pay down debt. In December 2012 the Scheme of Arrangement was terminated, and the company became free to pay dividends. The shares were bought for the various managed accounts shortly afterward, on the expectation that the company would soon resume dividends – and it did do so.

The consortium controlling Jaya is made up entirely of financial investors, so it is a given that Jaya will eventually be sold again, at which point it will be a good time for minority shareholders to exit too. The shares trade at about 70% of liquidation value.

k1 Ventures is a diversified investment company which operates as a private equity fund. There are 4 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, **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 337 locomotives and 5,368 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 9,597 railcars, 69 locomotives and 1,536 autoracks.

Railcar leasing demand has been strong, with utilization rates now at 93% versus 91% a year ago. In line with the positive outlook, Helm recently acquired 1,477 railcars and refurbished 102 locomotives.

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 in 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.

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.

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

China Grand Auto operates via its key subsidiary Guanghui Automobile. k1's effective stake is 1.6%. Guanghui has recently filed for a listing in Hong Kong. Should the listing occur, and k1 be able to divest, it should realize significant profits.

k1 is a special situation investment because since September 2007, the company's directors have decided not to make new investments, but to liquidate the existing investments and return the proceeds to shareholders. There is no specific timeframe for liquidation, but it has been going on for over 6 years, and it seems unlikely that it will take over 10 years for a full liquidation. The shares trade about 30% below a conservative estimate of revalued net asset value.

4. Currency Mismatch

A currency mismatch occurs when an entity's assets and liabilities are in different currencies. As a result, the entity's ability to remain solvent becomes at least partly a function of exchange rates.

During periods of economic stability, exchange rates fluctuate only mildly, leading some entities to take on currency risk with the expectation that either the status quo will continue indefinitely, or that they will be able to unwind the mismatch before the exchange rates move against them. Unfortunately, too many people, companies and even entire countries have found that exiting such mismatches in time is easier said than done.

"How did you go bankrupt?" Bill asked.
"Two ways," Mike said. "Gradually and then suddenly."

– Ernest Hemingway, *The Sun Also Rises*

Hemingway's character attributes his bankruptcy to "friends," and when there is a currency crisis the government of the day often blames external parties. Unfortunately, in many cases, deeper analysis shows the damage to be self-inflicted: it is merely the delayed payback for poor policies set in motion years earlier.

Government overspending is common enough; few countries regularly run a budget surplus. If the increase in accumulated deficit is small enough that economic growth outstrips it, this is not an issue. This is akin to someone borrowing a little more each year, but next year he earns more than the increase in borrowings, so that his debt-to-income ratio remains stable or even declines.

Given a low enough debt position at the start, people (and countries) can *increase* their debt-to-income (debt-to-GDP) ratio for some time without trouble. But eventually the accumulated debt becomes too expensive to service, and "sudden" bankruptcy (currency collapse) occurs. This is common sense, and is in fact the basis of the first-generation currency crisis model as described by Nobel laureate Paul Krugman in 1979[3].

Excessive foreign currency borrowings, which cannot be repaid via the domestic printing press, helped spark the 1997 Asian financial crisis. In the ensuing fallout, the Thai baht and Philippine peso lost more than half of their pre-crisis value against the benchmark US dollar. Indonesia was the hardest-hit: at one point the rupiah fell 80% against the dollar.

Seen through this lens, the implication for investors is simple: **avoid countries with heavy foreign currency borrowings**.

When it was realized that the first generation model did not fully describe all the known currency crises, it was developed further into a second- and now third-generation model.

In the third-generation model, private-sector balance sheets are in focus, specifically companies with foreign currency debt. These were in abundance in Thailand and Indonesia prior to 1997. They were essentially betting that their respective governments could continue to keep the exchange rate stable. They borrowed cheaply in US dollars to make high-yielding investments in baht or rupiah – or even simply left it in the bank to earn high rates of interest.

These interest rates were of course subsidized by the government, but eventually the sums involved became unserviceable, and the wheels fell off the bus, so to speak. With foreign currency liabilities suddenly doubling in local currency terms, companies and consumers alike were forced to deleverage, compounding the economic slowdown.

One might imagine that only emerging markets, with their supposedly unsophisticated financial infrastructure, would resort to such currency mismatches and suffer accordingly from the fallout.

In Australia, banks have long had an apparent currency mismatch. A strong economy growth and accompanying demand for credit left the banks short of funds, so starting in the late 1970s they turned to wholesale funding from abroad[4]. Today, about 1/3 of Australian bank loans is still funded by foreign currency loans. *But* the vast majority of such foreign loans are <u>hedged</u> back into Australian dollars, so in

[3] *A Model of Balance-of-Payments Crises*, Paul Krugman, **Journal of Money, Credit and Banking, Vol 11 No. 3 (Aug 1979) p311-325**.

[4] *Trends in the Funding and Lending Behaviour of Australian Banks*, Stewart, Robertson and Heath, **Reserve Bank of Australia, December 2013**.

effect there is very little net currency mismatch.

This prudence is another reason to consider Australia a developed or "mature" economy. This is not by itself a bad thing: "mature" may mean "not growing rapidly" but it also means "not behaving recklessly" – a rather important point that any investor interested in preserving his capital should appreciate.

As bottom-up investors in the securities issued by companies, it is mainly the third-generation model that interests us. For corporate balance sheets, the simplest thing to do is to simply avoid companies that are heavily indebted. Indeed, several of the companies in which the Fund is currently invested have the kind of balance sheet we describe with a single sentence: "The Group is debt-free, and cash on hand exceeds all liabilities".

The next simplest thing to do is to avoid companies with a currency mismatch – yes, despite the lessons of the 1997 Asian crisis, there remain companies who insist on having a currency mismatch. The two such entities to be discussed here are Religare Healthcare Trust ("RHT") and Lippo Malls Indonesia Retail Trust ("LMIR").

Both trusts are listed on the Singapore Exchange and trade in Singapore dollars. They also pay cash distributions in Singapore dollars. RHT operates in India, while LMIR operates in Indonesia.

Both receive rents in local currency i.e. Indian rupees and Indonesian rupiah respectively. Yet both have taken out Singapore dollar loans against their assets abroad. The reason, of course, is that it is cheaper to borrow Singapore dollars than Indian rupees or Indonesian rupiah. Obviously, this introduces currency risk into the company's operations. But there may be another issue lurking beneath the mismatch.

RHT's quarterly results for 30 September 2013 show distributable income of SGD 11.7m, or SGD 47m annualized, against property, plant and equipment of SGD 580m. Interest payments total SGD 2m annually. So before interest, the cash return is about SGD 49m, or 8.4% on SGD 580m of assets.

In comparison, 10-year bonds issued by the Indian government currently yield about 8.7%. Clearly, this means that RHT cannot have any meaningful borrowings in Indian rupees at all, because the rate of return on its Indian assets is below even the Indian government's cost of capital! This leads to the inescapable conclusion that either RHT's assets are <u>materially overvalued</u> and should be marked down to a level where the implied rate of return makes sense, or that they are being <u>poorly managed</u> and need to be restructured to earn returns commensurate with their valuations.

An investor might argue that such issues are already priced in, given that RHT trades at a trailing yield of 10.6%. Unfortunately, a closer look shows that this yield comes from financial engineering: the sponsor, Fortis Healthcare, has waived its share of distributions until 31 March 2014. Without the waiver, the yield would be 7.8%. Factor in the not-inconsiderable currency risk – the Indian rupee fell over 40% against the Singapore dollar in the last 5 years, a compounded annual loss of over *8% per year* – and it is clear that an investor in RHT today is taking on meaningful risk, with no certainty of a satisfactory return – or indeed *any* return at all.

As for LMIR, its latest results for the quarter ended 30 September 2013 show distributable income of SGD 19m, or SGD 76m annualized, against investment property of SGD 1.5bn. Interest payments total SGD 24m annually. So before interest, the cash return is about SGD 100m, or 6.7% on SGD 1.5bn of assets.

10-year Indonesian government bonds currently yield 9.1%. Thus, like RHT, LMIR cannot have any meaningful borrowings in Indonesian rupiah, since the rate of return on its Indonesian assets is below the Indonesian government's cost of capital. As with RHT, it seems that either the assets are overvalued, or there is a lot of room for operational improvements.

This brief analysis shows that the currency mismatches at RHT and LMIR are symptoms of a different and more serious problem: that neither trust is currently able to earn a reasonable rate of return on its assets, where "reasonable" is defined as exceeding the relevant government's own cost of borrowing.

Unitholders might want to ask the managers whether something is amiss. Common sense suggests that the official valuation of the trusts' property assets, and the implied rate of return earned on them, cannot both be correct.

So, in short, with regards to currency mismatches, whether at the national or corporate level, a simple rule of thumb is to just avoid them.

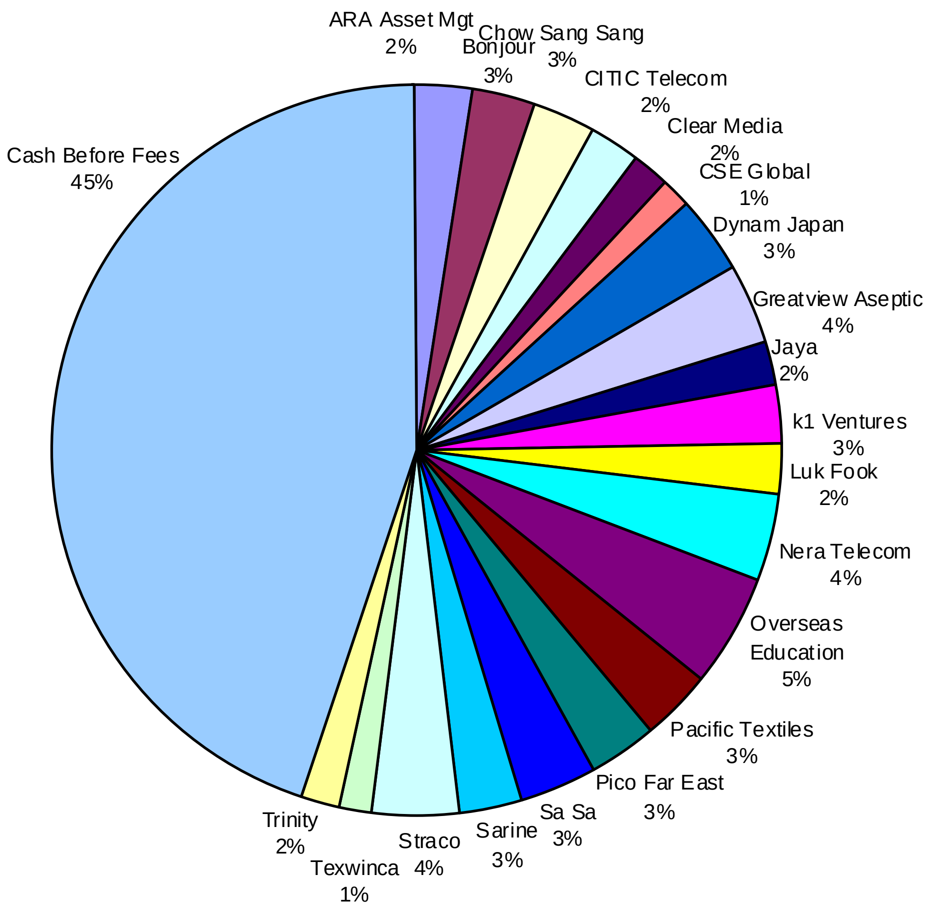
End

LIGHTHOUSE ADVISORS

Keeping Your Capital Safe

Annex I

Fund Holdings as of 31 Dec 2013



Annex II

Year	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	YTD
2013								100.00	100.86	102.24	102.63	102.93	+2.9%

Updated 24 February 2014