LIGHTHOUSE ADVISORS
Keeping Your Capital Safe

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Client Newsletter for the period ended 31 March 2014

1. Foreword

Fellow Investors,

Welcome to the Lighthouse Advisors newsletter for March 2014.

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

2. Market Commentary

The US recovery continues apace. In the first quarter, it expanded at an annual rate of just 0.1%, but other indicators suggest room for optimism.[1] The Federal Reserve believes the recovery is ongoing, and it will continue to reduce its monthly bond purchases. The jobless rate was 6.3% at the end of April, the lowest in over 5 years.

In Europe the economic recovery continues to be extremely uneven. The only economies that seem to be fine are the UK[2] and Germany[3].

Greece has made a comeback in the capital markets. The recent 10-year sovereign bond sale in April went off very well, at yields of just 4.95%. Compare this to the 30% yield demanded in 2012 prior to the debt restructuring, and one might think that Greece has recovered nicely. Sadly, this is not true. As the *Wall Street Journal* somberly puts it:

"A staggering 27% of the workforce is without a job, standards of living have been set back by a decade. Suicides have soared, and about a quarter of Greek households live close to the poverty line. One in six are unable to meet basic food needs."[4]

Elsewhere in Europe, the crisis in the Ukraine is escalating into a civil war as pro-European and pro-Russian forces clash. The European Union and the US have essentially left the Ukraine to fend for itself – which puts it at Russia's tender mercies.

Foot-stamping and table-banging rhetoric aside, the hesitation to offer military aid is understandable: unlike the 1990 Gulf War, where Iraq was armed with outdated conventional weapons and was an unimportant trading partner, in 2014 Russia sports a nuclear weapon arsenal and is a crucial energy supplier to Europe. Europe obtains about 30% of its gas needs from Russia. Half of this gas arrives via pipelines transiting the Ukraine.

Even if nuclear war is in nobody's interest, shutting off the gas flow to Europe is the obvious action for the Russians in any confrontation. This would perpetrate an energy crisis and risk economic collapse. The Europeans received previews of this in 2006 and 2009, when Russia reduced gas volumes flowing to the Ukraine over pricing disputes, creating downstream gas shortages in Western Europe. No prizes for guessing why Europe has not mobilized troops to the Ukraine.

The Ukrainians will have to accept that they are being pulled back into Russia's orbit,

[1] *U.S. economy stalls in first quarter, but fundamentals still sound*, **Reuters**, 30 April 2014.

[2] *UK economy grows at fastest pace in over six years*, **Reuters**, 29 April 2014.

[3] *April Monthly Report: German economy records very strong growth in first quarter*, **Deutsche Bundesbank**, 28 April 2014

[4] *Greece Gets Strong Demand for Bond*, **Wall Street Journal**, 10 April 2014.

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whether they like it or not. Crimea is already lost. It remains to be seen whether the rest of the Ukraine will split into two countries, one pro-Europe, the other pro-Russia.

In Asia, Japan's upcoming sales tax increase is likely to slow consumer spending. Japanese exporters are benefiting from a weaker yen, but in all likelihood the yen must weaken much further for the recovery to take hold.

China is taking aim at two very large problems: pollution and corruption. The Chinese Communist Party is finally accepting that the future of China – and the CCP itself – depends on how quickly and how well these are controlled. The Party is practical: elimination is too ambitious a goal. So far, corruption is proving a little easier to tackle than industrial pollution. Also, some corrupt officials became rich by letting industrialists flout environmental regulations; taking them and their cronies out will conveniently put the polluting plants out of commission too.

The most high-profile target of the current anti-corruption drive is Zhou Yongkang, who once headed the Politics and Law Commission, which oversees all the courts and police forces in China. On his watch, its budget grew to exceed even that of the Chinese military. The investigation of Zhou and his associates has been ongoing since late 2013. So far, the assets seized have reportedly totaled RMB 90bn (USD 14.5bn)[5].

The anti-corruption drive has trickled down to lesser officials too. It is becoming surreal: last year, 56 five-star hotels *downgraded* themselves to a four-star rating[6]. Their five-star ratings, once a prerequisite to draw officials, now drive those same officials away for fear of censure. Sharksfin exports from Hong Kong to China have fallen 90%, perhaps from environmental consciousness, but more likely from a cutback on conspicuous consumption. Premium liquor distillers Wuliangye Yibin and Kweichow Moutai are guiding for a slow 2014, while high-end restaurants have reported poorer sales in the wake of the austerity drive[7].

Hong Kong's Hang Seng Index is dominated by Chinese state-owned enterprises in finance, energy and real estate. Banks and property developers, in particular, continue to be weighed down by fears of a hard landing or a credit crunch. Unsurprisingly, the Hong Kong market has not done well so far this year.

Given the multi-year bear market for real estate stocks, valuations are becoming interesting. Continued growth in the underlying asset values has widened the pricing discounts in the stock market. After 4 years of near-zero exposure, your manager has begun to devote significant time to this sector.

The political impasse continues in Thailand. Stock prices there have yet to decline to interesting levels, so the market still merits observation rather than actual participation.

As seen most obviously in Greece, investor perceptions change faster than reality. But that is the nature of capital markets, where irrational over-reaction and not rational response is the norm.

Your manager considers the outlook for the portfolio to be promising, and continues to invest more money into the Fund. The next newsletter will be published for the quarter ended 30 June 2014.

Benjamin Koh
Investment Manager
Lighthouse Advisors
6 May 2014

[5] *China seizes $14.5 billion assets from family, associates of ex-security chief*, **Reuters**, 30 March 2014.

[6] *No more shark fins, whiskey and Prada: The strange signs of China's corruption crackdown*, **The Washington Post**, 9 April 2014.

[7] *Xi's Corruption Crackdown hits China's Restaurants*, **Bloomberg Businessweek**, 21 April 2014.

3. Portfolio Review

As at 31 March 2014, the Net Asset Value (NAV) of the Fund was USD 99.80. Net of all fees, the year-to-date return was -3.0%.

21 securities made up 85% 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.

New Investments

Frasers Centrepoint Limited (FCL) is the property arm of conglomerate Fraser & Neave (F&N). Charoen Sirivadhanabhakdi, a Thai tycoon, acquired control of F&N in 2012. FCL was demerged and separately listed in 2013.

FCL has a large portfolio of pre-sold development properties in Singapore, China and Australia. The development profits will be recognized over the next 2-3 years.

More interestingly, FCL will recycle capital by moving investment property assets off its balance sheet and into real estate investment trusts (REITs) that it manages. Currently, it manages Frasers Centrepoint Trust and Frasers Commercial Trust, which hold retail and office properties respectively.

FCL has also received approval to list a hospitality trust. It owns some 2,400 serviced apartments and manages over 12,000 third-party rooms. The self-owned apartments and management rights for the third-party rooms will likely be injected into the trust.

The stock market is currently valuing FCL as a property holding company i.e. at a discount to its net asset value. However, most of the investment property assets will eventually be sold to the REITs for cash. This cash will most likely be paid out to shareholders because Thai Beverage and TCC Assets, the companies that Charoen Sirivadhanabhakdi used to bid for F&N, took on significant debt for the deal. Thai Beverage and TCC Assets together own 90% of FCL and would receive the bulk of any cash payout. Additionally, FCL has committed to a 75% dividend payout policy, so most of the development profits will be paid out also.

FCL is a "special situation" investment driven by corporate restructuring. The shares were acquired at less than 60% of revalued net asset value. Forward yield was about 7%.

OUE is a property holding company. Founded in 1964 as the property arm of the OUB Group, it is today 68% owned by Lippo ASM Asia Property, which is jointly controlled by the Lippo Group of Indonesia and Argyle Street Management.

OUE has in recent years begun to specialize in brownfield property developments, where it buys existing properties with untapped potential, then enhances them to improve the value. The showcase projects for this were the Meritus Mandarin Hotel and OUB Centre.

The refurbishment of Meritus Mandarin resulted in the creation of the Mandarin Gallery retail mall. Meritus Mandarin was renamed Mandarin Orchard. Along with Mandarin Gallery, it was later sold to OUE Hospitality Trust, which is managed by OUE.

At OUB Centre, a second office tower was constructed next to the first tower. OUB Centre has since been renamed One Raffles Place. Its adjacent shopping mall is now undergoing refurbishment. Once completed and rent-stabilized, the entire complex is likely to be sold to OUE Commercial REIT, which is also managed by OUE.

Other assets undergoing enhancement and conversion include Crowne Plaza Changi Airport Hotel, OUE Downtown, and US Bank Tower. It is all but certain that these will later be sold to vehicles managed by OUE.

Like FCL, OUE is a "special situation" investment where a property owner is restructuring to become a property manager. Assets will be sold off to captive trusts, and the proceeds returned to shareholders.

The divest-and-pay corporate activity is already underway. After the launch of OUE Hospitality Trust, a special dividend was paid in 2012, and in 2013 a dividend-in-specie of OUE Hospitality Trust units was declared. The pattern of cash and in-specie dividends will likely continue with OUE Commercial REIT.

The shares were acquired at about 50% of revalued net asset value. Forward yield was about 4%.

OUE Hospitality Trust is a real estate investment trust (REIT) investing in hospitality assets such as hotels and serviced apartments. Its key assets are the Mandarin Orchard Hotel in Singapore and the attached Mandarin Gallery retail mall. The REIT units were received as a dividend-in-specie from OUE and have already been sold for cash.

Divestments

Jaya announced that it had reached an agreement to sell its entire business to Mermaid Marine of Australia. This was the exit event that your manager was waiting for. The company announced that it would pay a special dividend, plus a return of capital to shareholders. The shares traded very close to your manager's estimate of final realizable value, so the decision was made to sell early. Gain on divestment was approximately 15%.

Texwinca was sold as its retail business continued to suffer in China's competitive environment. The textile segment remained steady, but was unable to compensate for the decline in retailing. Given the valuations presented in the stock market, your manager decided to sell and deploy the capital elsewhere. Gain on divestment was about 5%.

Other Significant Events

k1 Ventures announced a sale of its 80.1% interest in Helm Financial to Wells Fargo Bank for USD 152m (SGD 192m). The proceeds amount to over 9 cents per share or over 45% of the current market price. This transaction materially improves the expected IRR of the Fund's investment in k1 shares.

4. Interest Income

Unless the company is a bank or finance company, "interest income" is usually not very… *interesting*. But sometimes, this boring one-line item can reveal useful information.

Here we are concerned with 2 cases: when interest income is significant compared to income from operations, and when a company both receives *and* pays significant interest.

Interest for non-financial companies is usually incidental to operations, but some companies derive significant income from their cash balances. For example, take Lianhua Supermarket Holdings, which is listed in Hong Kong. It operates hypermarkets, supermarkets and convenience stores. Lianhua went public in 2003. For the next several years, things appeared to be normal: sales increased, profits increased, and dividends increased. All good, or so it seemed.

But starting in 2008, something unusual happened: Lianhua began receiving large amounts of interest income. A look at the balance sheet revealed that Lianhua held almost RMB 7bn in cash at the end of 2008, compared to less than RMB 800m at the end of 2003, the year it listed.

Cumulative profits from 2003-2008 were just over RMB 1bn. Where did Lianhua find RMB 6bn? The answer lies in the liabilities section of the balance sheet. In 2008 Lianhua booked RMB 6bn of "coupon liabilities". Such liabilities were only RMB 35m at the end of 2003. Mystery solved. Lianhua had found a "magic formula" for easy money: sell coupons for later redemption and deposit the cash in the bank to earn risk-free profits.

How important was this free money? In 2003 interest income from bank deposits accounted for less than 2% of operating profits. In 2008 it accounted for 35% of operating profits. In

2013 it accounted for *158%* of operating profits. That is not a typo – excluding the bank interest, Lianhua made operating losses in 2013. Unsurprisingly, shareholders have not done well: from its peak of over HKD 20 in 2011, the stock trades at a little more than HKD 4 today, a loss of some 75% of its market capitalization in two and a half years.

Could shareholders have avoided the losses? From July 2010 through June 2011, a full 12 months, the shares sold for HKD 15-20 each, valuing the company at HKD 16-22bn (RMB 13-18bn). Lianhua earned RMB 507m in 2009 and RMB 623m in 2010.

Even the most charitable valuation of RMB 13bn for profits of RMB 623m implied a price/earnings ratio of over 20 times. Lianhua would have to be growing rapidly to justify such a valuation. But its financial income, derived from bank deposits and financial assets, plus fair value changes of financial assets, was RMB 248m and RMB 284m in 2009 and 2010 respectively. After a 25% credit for corporate tax, the adjustments needed would be RMB 186m and RMB 213m. So excluding financial income, Lianhua actually earned about RMB 321m in 2009 and about RMB 410m in 2010.

Using the adjusted earnings of RMB 410m, the price/earnings ratio was over 31 times, a lofty valuation for a business that earned 3% operating margins in its "best" year. And this was before excluding the financial income. Any sensible shareholder interested in preservation of capital should have sold in a hurry. Yet the shares traded at such levels, and higher, for 12 months. Hardly an efficient market, then.

In any case, the point here is that interest income was so large that it distorted the picture of the company's underlying earnings. Thanks to market inefficiency, an alert shareholder would have had plenty of time to exit at a good price. Anyone who did not bother to read the financial statements and subsequently suffered as the shares tumbled in value had only themselves to blame.

A secondary point is that when incidental income becomes highly material to total income, management can get distracted from the core business. When conditions are no longer benign, the business can suffer a drastic reversal – as Lianhua has experienced.

The second case to be considered is when a company both receives *and* pays significant interest. At first glance, this seems irrational. Why not simply use the interest-earning cash to pay off the interest-bearing debt?

Texwinca is a textile manufacturing company listed in Hong Kong. It exports its products worldwide, mainly to Europe and the US. It also owns the budget retail apparel brand Baleno, which gets most of its sales in China.

For the last several years, Texwinca's cash on hand has nearly equaled or even exceeded its debt. However, for Texwinca, the interest rate it receives on its cash deposits exceeds the interest rate it pays on its debt. This "positive carry" arbitrage is possible because Texwinca functions in 2 currencies: its local operations in China consume RMB, while its export sales generate USD.

Because its export customers pay in USD, Texwinca can safely borrow in USD – and it does, enjoying the current low interest rates. At the same time, its operations in China require RMB, so it can safely convert additional RMB in excess of immediate requirements to deposit at banks to earn higher interest. In FY2012 and FY2013, Texwinca's bank debt cost 1.1-1.5%, while its bank deposits earned over 4%. Texwinca can undo the arbitrage any time by using customer payments to pay off the USD debt, and using the RMB deposits to pay operating expenses. Of course, Texwinca runs the risk of adverse currency movements – but this is already embedded in its export-driven business model.

So Texwinca is a case where it makes sense to have both significant cash *and* significant debt – because there is a positive carry. But not every company has a positive carry.

EcoGreen Fine Chemical is also listed in Hong Kong. It produces chemicals for the flavours and fragrances industry. In 2013 chemicals manufacturing accounted for about three-quarters of turnover. Aroma chemical sales made up about three-quarters of all chemicals manufacturing.

A brief look at the balance sheet suggests that EcoGreen's financial position is stronger than that of Texwinca. Since IPO in 2004, EcoGreen has had cash exceeding its debt. Normally this would be considered a good thing. But a look at the implied interest rates hints at a different story.

From 2004 to 2013, EcoGreen paid interest on its debt at rates ranging from 4.4% to 7.5%, while receiving interest on its cash at rates of 0.5% to 1.1%. In other words, for 10 consecutive years the company was in a "negative carry" position even though it had sufficient funds to pay off all its debt. This is irrational behaviour and a clear red flag.

Although these facts alone do not prove that EcoGreen is a fraud, its dividend payout ratio has also been persistently and worryingly low. Since IPO, payouts have ranged from 13% to 22% of profits. Cumulative payouts are just 16% of profits earned since IPO. Capital expenditure is not a valid excuse, as cumulative free cash flow in the same period totaled over two-thirds of reported profits.

One might even wonder if the cash is actually there. After all, if Texwinca can earn 4% on its cash, why can't EcoGreen do so too? If we assume EcoGreen is in fact earning 3% on its cash, that means that the real cash balance is only one-third the reported amount. Of course, without physical verification, it is impossible to know for sure. But the data are suspicious.

Another point for concern is that despite booking plenty of profits and accumulating a tidy cash pile of RMB 933m, debt has actually increased over the years, from RMB 128m in 2004 to RMB 736m in 2013.

It seems silly to keep borrowing more money while cash accumulates in the bank, especially in a negative carry situation. The company's 2013 annual report states that a 3-year syndicated loan of USD 66m (RMB 446m) was taken out to fund major projects at 3 sites, and that internal reserves would be used together with the loan proceeds. However, past records show that the company only spends about RMB 60m per year on capital expenditure. The one year of significant spending was 2007, when it spent RMB 148m. It seems odd that the company would now take on 3 simultaneous projects costing several times this amount in total.

Indeed, if the project is 50/50 funded by cash reserves and the loan, the total investment would be almost 3 times the company's current investment in plant, property and equipment, and about one-and-a-half times what the company has cumulatively spent since IPO. This seems rather ambitious given the company's historical spending record.

Furthermore, current operations appear to be deteriorating: trade and bill receivables increased to 156 days of sales at end-2013, the highest in the company's public history. Since listing, accounts receivables have hovered at about 100 days of sales, but in 2010 it increased to 117 days, in 2011 it was 123 days, in 2012 it was 130 days, and now in 2013 it stands at 156 days. This trend is even more obvious when the interim results are taken into account and the receivable days are tracked on a six-monthly basis. Significant bad debt provisions may well be forthcoming in the near future.

One might argue that such warning signs are why the company trades at a meaningful discount: just below 5 times 2013 earnings, and less than 0.6 times book value. Investors must decide for themselves if the risk is worth the potential reward.

In conclusion, interest income can sometimes be… *interesting*.

End

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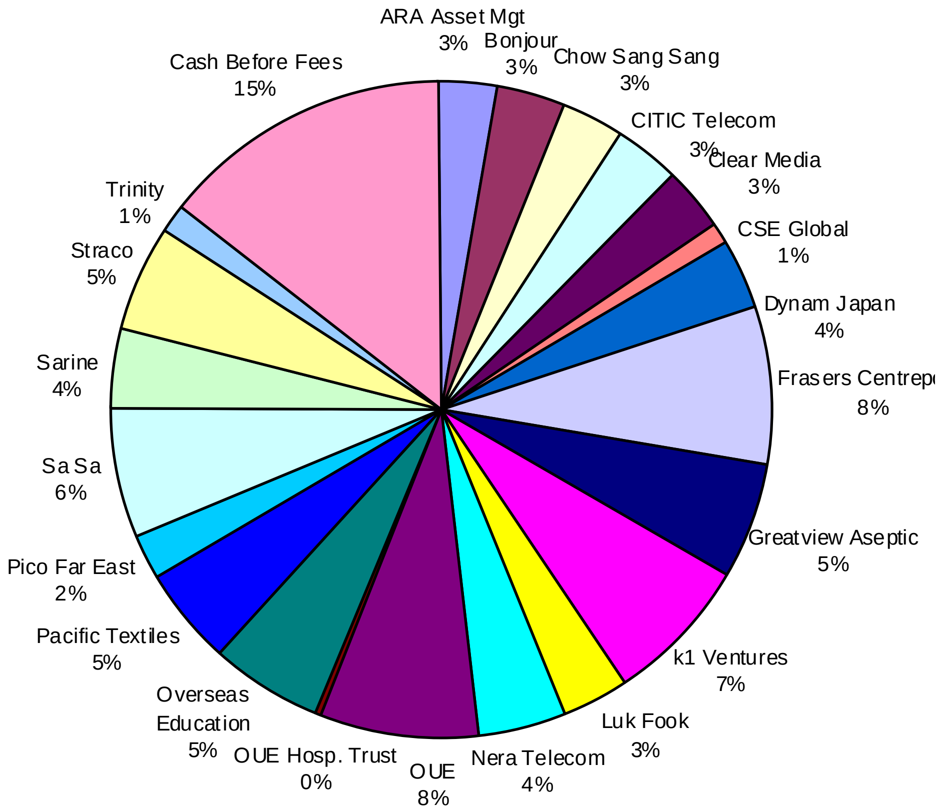
Annex I

Fund Holdings as of 31 Mar 2014



Annex II

	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%**
2014	99.15	101.78	99.80										**-3.0%**

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