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Client Newsletter for the period ended 30 June 2014

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1. Foreword

Fellow Investors,

Welcome to the Lighthouse Advisors newsletter for June 2014.

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

2. Market Commentary

The US economy continues to improve, although the benefits are flowing mainly to corporations, which are enjoying cost savings from depressed wages. Still, job creation is strong, averaging over 200,000 jobs per month over the last 6 months. The jobless rate was 6.2% at the end of July[1].

In Europe, the UK and Germany are still the clear leaders in the region's recovery. The UK home-building industry is playing catch-up to the recovery in the housing market, resulting in the 15th consecutive month of increased construction activity[2]. In Germany, however, some dark clouds are forming on the horizon, due to sanctions on doing business with Russia on account of the situation in the Ukraine[3].

The civil war in the Ukraine has claimed a high-profile victim, as a Malaysian Airlines passenger jet flying from Amsterdam to Kuala Lumpur was shot down over the Ukraine by an anti-aircraft missile. The Ukrainian government and the pro-Russia rebels each blame the other side for the tragedy. What is clear is that the missile system used required professional training. So if it was indeed the rebels, they must have received help from Russia, the original supplier of the missile system. The rebels have retrieved the black boxes and turned them over to Malaysia, which has in turn sent them to the UK for analysis. Meanwhile, the accusations and finger-pointing continue.

In China, the authorities have finally announced the investigation of Zhou Yongkang, making it official nearly two years after rumours first swirled that he was in trouble. Further down the ranks, continued cutbacks on extravagance have dented the fortunes of companies catering to the rich and powerful, while slower growth in the consumer sector has led many companies to scale back their expansion plans and reduce inventory holdings.

Japan's government spending is set to increase as it prepares to host the 2020 Olympics in Tokyo. Many investors are now jumping into the Japanese market in the hopes that companies involved in the buildup to 2020 will benefit. Others, more circumspect after the huge rally last year, continue to sell.

Your manager recently visited Vietnam. The country has promising demographics: a large, young population, an emerging middle class, and an economy that is changing from centralized planning to free market capitalism.

However, everything is relative. Problems persist in the form of inflation, non-performing loans, government interference and rampant overinvestment in many sectors. Given these issues, cheap stock prices are a

[1] *Employment Situation Summary*, **Bureau of Labor Statistics**, 1 August 2014.

[2] *UK housebuilding grows at fastest rate since 2003,* **Reuters**, 4 August 2014.

[3] *The Boomerang Effect: Sanctions on Russia hit German Economy Hard,* **Spiegel**, 21 July 2014.

basic requirement, but they are rather sparse on the ground. Many companies are also already at the 49% foreign shareholding limit.

Your manager continues to uncover special situation investments for the Fund. The next newsletter will be published for the quarter ended 30 September 2014.

Benjamin Koh
Investment Manager
Lighthouse Advisors
6 August 2014

3. Portfolio Review

As at 30 June 2014, the Net Asset Value (NAV) of the Fund was USD 106.57. Net of all fees, the year-to-date return was 3.5%.

19 securities made up 84% 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

SBS Transit (SBS) is the largest operator of public bus services in Singapore. It owns and operates about 75% of the total bus fleet. It also runs the Northeast Line of the Mass Rapid Transit (MRT) subway.

Currently, public transport fares can only be partially adjusted for wage inflation, and any increase must be approved by the Public Transport Council. Public unhappiness with higher fares has meant that historically, fare increases have lagged cost increases. More importantly, other significant input costs, most notably fuel, are simply absent in the fare adjustment formula. As a result, in recent years, the bus segment has been loss-making, due mainly to increases in fuel costs which the company has been unable to pass on to commuters.

After much debate over whether public transport operators should be profit-driven commercial entities or service-driven taxpayer-funded entities, the Singapore government has decided on the latter. It recently announced that after the current Bus Service Operating Licences for the 2 local bus operators expire in August 2016, the government will take over all the bus infrastructure, including depots, buses and the fleet management systems. The current buy-own-operate model of the bus companies will change to a pure fee-for-service operator model, where the bus companies will bid for various route packages to be determined by the government.

In this way, the government will pay the bus companies enough to allow them a reasonable margin, while the bus operators will only be responsible for service delivery. All fares collected will go to the government. If there is a shortfall or surplus, the government and not the operators will absorb the difference. As the operators will no longer need to own buses, the entry barriers are lowered, allowing more competitors and hopefully better service.

As the dominant operator today, SBS should remain the largest operator post-2016, although it is likely to suffer some loss of market share. After the restructuring in 2016, SBS' bus-related assets will convert to cash which it will not need in its new asset-light business model. After paying down debt, the balance will probably be paid out as a special dividend and/or return of capital. What remains is a service company capable of generating high returns on equity and paying out a large proportion of earnings as dividends.

Obviously, SBS is a "special situation" investment driven by corporate restructuring. The shares were acquired at less than 60% of revalued net asset value. Net of the expected special dividend and return of capital, the adjusted cost basis implies a valuation of just 4 times post-restructuring earnings, with an estimated 16% dividend yield.

Divestments

CSE Global was sold due to a loss of leadership. One co-founder has retired from active management but remains as an advisor, while the other co-founder is now CEO of the divested UK business and is no longer with the Group. After accounting for dividends received, loss on divestment was about 5%.

Trinity was sold as its retail business continued to suffer in China's competitive environment. Longer term, the shift in consumer spending away from department stores towards shopping malls will hurt Trinity, as most of their sales points are inside department stores.

The current anti-corruption drive is also cutting into sales, as government officials are receiving fewer department store vouchers as gifts. Most officials are men, and given a department store voucher, a man will generally spend it on a luxury watch, a nice suit, and a smart pair of shoes. No vouchers means no spending, which means no sales for Trinity either.

It is not clear how much longer Trinity will suffer, nor what its normalized earning power will be. Given the valuations presented in the stock market, your manager decided to sell and deploy the capital elsewhere. The loss on divestment was about 30%.

Other Significant Events

Frasers Centrepoint Limited has announced an all-cash bid for Australian developer Australand, trumping a cash-and-stock bid by rival property group Stockland. Australand is one of Australia's largest property groups, with A$2.4bn of investment properties and A$9.3bn of development properties.

If the deal succeeds, it will likely be funded entirely by debt. The company will probably offload some of Australand's development assets quickly, whether to Stockland or to its own partners such as Japanese developer Sekisui House. The investment properties should eventually be sold to the real estate investment trusts managed by Frasers Centrepoint, which will create lasting value in the form of increased management fees.

4. Sovereign Risk

For investors, sovereign risk is usually considered to be the risk that a nation will default on its bond obligations, Argentina being the latest such example. But sovereign risk can also be viewed as the risk that a government may do things that are detrimental to investors, whether defaulting on debt, changing regulations or something else. It can be considered as a superset of regulatory risk, since governments can move against investors without changing the law.

Many "macro" or "top-down" investors first decide that country X is likely to do well economically in the coming months or years, then buy the largest companies listed on the stock exchange, reasoning that the largest companies represent so large a proportion of the economy that when the country does well, these companies will automatically do well too. This is often also done on a smaller scale with industrial sectors.

"For years I thought that what was good for our country was good for General Motors, and vice versa. The difference did not exist. Our company is too big. It goes with the welfare of the country. Our contribution to the nation is considerable."

– Charles Erwin Wilson,
confirmation hearings before the Senate
Armed Services Committee, 1952

Such a top-down strategy ignores the fact that the interests of shareholders and other stakeholders, especially the government, may be diametrically opposed. A brief walk through some of the more important industrial sectors will show why governments may make decisions to the detriment of shareholders, even when the governments are themselves the largest shareholders.

In banking, the overriding concern of governments is that the banks function normally. In other words, companies can borrow money as needed for investment and working capital, suppliers can get paid, customers can pay, etc. But shareholders want more than a normally functioning banking sector: they want profitable banks, where loans earn a sufficient rate of interest to compensate for the risk of default.

Herein lies a conflict of interest: shareholders want banks to be strict in underwriting loans, to increase the rates of interest charged, or to simply not lend when default risk is too high. But governments want banks to continue lending, to keep liquidity flowing and the economy functioning. As a result, a government may compel the banks to lend money regardless of the default risk. At banks where the government is the largest shareholder, the government can simply order the executives to increase or decrease lending at will. There are also other policy tools such as the reserve ratio, loan-to-deposit ratio and so on, but they all essentially adjust the availability of credit in the banking system.

In China, the "Big Four" banks i.e. **Bank of China** (BOC), **Industrial and Commercial Bank of China** (ICBC), **Agricultural Bank of China** (ABC) and **China Construction Bank** (CCB) are all majority-owned by the state. This means that loan policy is ultimately a political decision and not an economic one. When politics and economics collide, economics is almost always the loser.

When loans are made for political and not economic reasons, it is a matter of time before they go bad. What happens when too many loans go bad? Simple – do a rights issue. Since the state only owns just over half of the banks, the cost of a bailout is also halved. In other words, when the bank loans perform, China reaps the full benefit, but when the loans go bad, half the cost is shared with helpful foreign investors eager to participate in the world's second largest economy.

With such an asymmetric risk/reward ratio, the inherent moral hazard cannot be overstated.

A simple look at history shows that BOC and ICBC and CCB all had rights issue in 2010. ABC did not do a rights issue because it had its IPO that same year. The rights issues increased the capital base of the banks – good for them. But the rights issues also forced shareholders to increase their financial commitment to the banks on pain of dilution – not quite so good for them.

Foreign investors are now excited that the fifth-largest bank, **Bank of Communications**, is looking to sell shares to private investors. These investors would do well to be wary instead. As long as the government holds a majority stake, it can do as it pleases, and no amount of foreign ownership can induce it to act on a purely commercial basis.

Another sector where interests diverge is toll roads. Toll roads are attractive cash-generating assets for investors, but a nuisance for motorists. Governments may prioritize local connectivity over the sanctity of toll road contracts, in which case they can unilaterally adjust the toll road concession. Or they may simply build a competing toll-free road to increase overall throughput – which will of course draw traffic away from the tolled road.

A case in point: in 2007 the **Macquarie Infrastructure Investment Fund** (MIIF) acquired an 81% interest in the Hua Nan Expressway (HNE), a 31-kilometre dual-carriage urban toll road in Guangzhou, the capital of Guangdong, China. Unfortunately for MIIF, in December 2010, a competing government-owned toll road, the Xinguang Expressway, was detolled. The result was diversion of traffic away from HNE, reducing toll collections. Then, in June 2012, the government of Guangdong implemented revisions to the toll rates which cut toll revenues further. Neither action was accompanied by compensation from the local government, so MIIF shareholders suffered.

Another example, this time from the consumer sector in China, is cooking oil. This is considered an essential item. Price controls were lifted in 2011, but the government still "advises" producers not to raise prices unless it is absolutely necessary. The companies cooperate accordingly since they do not wish to offend the government.

What this price restraint means is that companies like **Wilmar International** struggle to earn a reasonable profit in China. Wilmar's *Arowana* brand holds a 45% market share in the Chinese edible oils market. Yet, over the past 7 years, Wilmar's reported margins for its consumer products segment were 4.1%, 1.6%, 5.8%, 3.2%, 1.3%, 2.2% and 2.9% from 2007 through 2013, with an average margin of just 3%. Margins in the post-price control years of 2012 and 2013 were actually *worse* than average. All in all, these are hardly numbers worthy of a company that dominates the market.

Enough on China. What about Thailand? Thailand is a favourite among foreign investors because, domestic politics aside, it has been business as usual through the last 12 coups. Throughout the protests and clashes, foreigners have largely been spared. The stock market's stunning recovery post-1997 has also given foreign investors great confidence to invest whenever Thailand has a crisis.

Still, investors should take note of what is happening with rice. The government is sitting on a veritable mountain of spoilt rice. Under the previous government's rice pledging scheme, rice was bought from farmers at above-market prices, then piled up in warehouses, to be sold at some future date when global rice prices were more favourable. That day has not yet arrived, and so far 100,000 tons of rice has been designated as spoilt and unfit for human consumption.

PTT, the local petrochemical conglomerate, has helpfully suggested that it can use the rotten rice to make ethanol. The Thai Finance Ministry in turn wants to sell the rotten rice stockpiles at 20% of the pledging price. But the pledge was done at 40% above market prices, implying that the selling price for rotten rice will be 28% of the market price of unspoilt rice. **Logic dictates that the market price of spoilt rice should be near zero.** Unfortunately for minority shareholders of PTT, the Thai Ministry of Finance just happens to own 51% of PTT. No prizes for guessing what price PTT will pay for the rotten rice.

These examples should drive home the point that the interests of the government need to be considered when making an investment decision. Even if – perhaps *especially* if – the government is the largest shareholder, it does not mean that it will act in its own interests as a shareholder. The government's larger goal is its continued survival, and this may mean sacrificing shareholder returns in exchange for political capital. Minority shareholders then become collateral damage – an unfortunate, but unavoidable cost. Prudent investors would do well to steer clear of companies subject to such sovereign risk. Or, to put it more simply: **don't fight the government**.

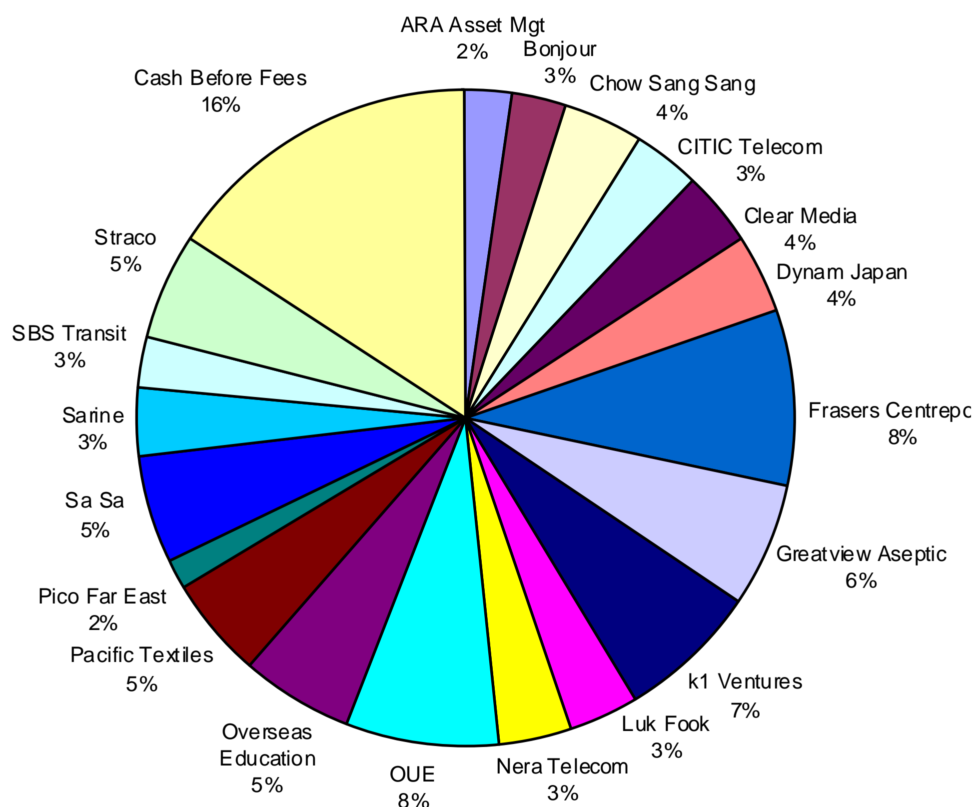
~ End ~

LIGHTHOUSE ADVISORS

Keeping Your Capital Safe

Annex I

Fund Holdings as of 30 Jun 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	101.84	105.45	106.57							**+3.5%**

Updated 6 August 2014