Lighthouse Advisors Private Limited
Reg. No. 201212773E
10 Anson Road, #38-03 Unit A
International Plaza, Singapore 079903
www.lighthouse-advisors.com

Client Newsletter for the period ended 30 September 2014

1. **Foreword**
2. **Market Commentary**
3. **Portfolio Review**
4. **Fishy Business**

1. Foreword

Fellow Investors,

Welcome to the Lighthouse Advisors newsletter for September 2014.

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

2. Market Commentary

In the US, the jobless rate was 5.9% at the end of September[1]. This is a six-year low and points to future wage pressure for companies and in turn better times ahead for workers. In hindsight, the Federal Reserve's extraordinary purchases seem to have worked, even as they have now been halted.

In Europe, these effects have not gone unnoticed, and a "zero interest rate" policy has become increasingly acceptable, even popular. Sweden's central bank recently cut short-term interest rates to zero[2], while German 7-year "bunds" now yield just 0.7%, unadjusted for inflation.

Low interest rates have proven advantageous to corporate borrowers. Hutchison Whampoa recently sold new EUR and USD bonds at highly favorable rates[3]. The highest coupon rate it will pay for the new bonds is just 3.625%, and this is for the 10-year bond. For the company, the low rates are a god-send. But for retirees trying to get by on bond coupons, the low-income nightmare looks set to continue.

In China, the official Purchasing Managers Index hit a 5-month low in October at just 50.8, indicating that industrial expansion is clearly slowing down. The official target growth rate for China's economy is 7.5% in 2014. This is still healthy by any measure, but the cracks are showing. Bad loans, for one, have drastically increased at the banks, albeit from very low levels.[4]

Perhaps a better "canary in the coal mine" for China is Australia. China is Australia's largest trading partner, taking up fully one third of its total exports. Over half its export sales to China are iron ores and concentrates. Iron ore prices are at 5-year lows, and Australia's fortunes have followed. Unemployment was 6.1% in August versus 5.1% two years ago. Mining giant BHP Biliton is cutting jobs in iron ore and coal mining, while archrival Rio Tinto is diversifying into cattle ranching[5]. China bulls should keep one eye on Australia.

In Hong Kong, Occupy Central continues. Conceived as "Occupy Central with Love and Peace", a peaceful act of civil disobedience, it took on a life of its own when the Hong Kong Federation of Students and student activist group Scholarism initiated a class boycott which spiraled into the students occupying parts of Central and Causeway Bay, blocking vehicular traffic.

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

[2] *How low can you go? Sweden cuts interest rates to zero*, **Telegraph**, 28 October 2014.

[3] *Hutchison sells largest corporate bond from Asia ahead of FOMC*, **International Financing Review**, 29 October 2014.

[4] *Bad Loans Rise at China's Biggest Banks*, **Wall Street Journal**, 30 October 2014.

[5] *Australian Economy Changes as Exports to China Slow*, **Bloomberg Businessweek**, 25 September 2014.

Early on, the police responded forcefully with tear gas, but this stirred public outrage, and tens of thousands of Hong Kong residents took to the streets in anger. Amid widespread condemnation, the police have backed off, and instead of a Tiananmen-style crackdown, the Hong Kong government is now opting to wait out the protesters[6].

For retailers in Hong Kong, Occupy Central has clear negative long-term repercussions. Even though the occupation will eventually end and shopper foot traffic will return, Hong Kong's reputation as a peaceful shopper's paradise has been forever changed. Mainland Chinese will be more wary about shopping in Hong Kong, which will hurt companies which depend heavily on Chinese tourists for business. On the other hand, for companies whose operations are primarily or even entirely in China, Occupy Central is of no economic consequence.

Occupy Central is unlikely to change the status quo in Hong Kong; the Basic Law as written is so vague that Beijing has not actually broken the *letter* of the law[7]. Under Beijing's interpretation, Hong Kong will have "one person, one vote" to *elect* its Chief Executive, but it cannot freely *nominate* the candidates who will actually stand for election. Pro-democracy activists have denounced this as absurd, but it is perfectly legal within the language of the Basic Law.

So, to sum up affairs worldwide, the obvious global economic trends are that the US is doing well, but Europe is not, and China and Australia are slowing down. What does it mean for a bottom-up investor such as your manager? Very little, except perhaps to avoid the obvious portholes where indebted companies fall prey to rising interest rates, or commodity suppliers face declining prices.

[6] *Hong Kong Government Wages War of Attrition*, **Bloomberg Businessweek**, 29 October 2014.

[7] *Hong Kong protests: Did China go back on its promises?* **BBC News**, 2 October 2014.

The next newsletter will be published for the quarter and year ended 31 December 2014.

Benjamin Koh
Investment Manager
Lighthouse Advisors
15 November 2014

3. Portfolio Review

As at 30 September 2014, the Net Asset Value (NAV) of the Fund was USD 103.60. Net of all fees, the year-to-date return was 0.7%.

19 securities made up 87% 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.

<u>New Investments</u>

There were no new investments made during the period.

<u>Divestments</u>

There were no divestments for the period.

<u>Other Significant Events</u>

Frasers Centrepoint Limited has successfully privatized Australand, acquiring a portfolio comprising A$2.4bn of investment properties and A$9.3bn of development properties. The deal was funded entirely by debt, in particular $200m of 7-year notes at 3.95% and $600m of perpetual debt at 4.88%. These are highly advantageous rates given their long tenure, and shareholders are likely to benefit over the long term.

4. Fishy Business

Since time immemorial, humans have set out to sea in boats, with the goal of returning with a full load of fish to sell. But changes in technology have far outstripped the fishes' ability to evolve in response. Modern fleets have dramatically changed the landscape.

Ships are now able to venture far offshore for months at a time, with on-board freezers capable of storing vast quantities of fish.

What has not changed is the fishes' ability, or lack thereof, to evade capture. Their tendency to swim in schools provides protection in numbers against predators, but makes for easy capture in seine nets. The result is the slow-but-sure extermination of fish stocks as ever-improving technology allows humans to chase ever-decreasing numbers of fish.

The abundance of the ocean is at once its greatest strength and also its greatest weakness. When the fish are so abundant as to be uncountable, they are fished as if their supply is endless, until they become so few that their demise is obvious. This is the sad history of commercial fishing.

Several major fisheries have seen catches decline by 90% from their peak. Overfishing has been pinpointed as the major cause in nearly all these cases, while weather effects, notably El Niño, have also been blamed. Spectacular examples of such collapse include the California sardine fishery in the 1950s, the Peruvian anchovy fishery in the 1970s, the Atlanto-Scandian herring fishery in the late 1960s, and the Northern cod of the east coast of Canada in 1992. More recently, in July this year it was revealed that the Pacific bluefin tuna population is down to just 4% of its original size.

According to the United Nations' Food and Agriculture Organization (FAO) report *The State of World Fisheries and Aquaculture 2014*, the total global "capture production" of fish caught inland and at sea has stagnated at about 90m tons since 2007. This stability might sound like good news, but the same report notes that almost 29% of assessed fish stocks are classified as overfished. In other words, the fish stocks in question are expected to decline over time unless appropriate measures are put in place.

In recent years, increasing awareness of overfishing has led some governments to aggressively manage their fisheries by slashing the allowable catch. There has been some success, notably in the US, Iceland and New Zealand, but the majority of fishing still occurs in less-developed countries, where short-term pressure to feed people and generate export earnings can trump strategic longer-term considerations.

Fishing quotas may be set too high, or offenders may not be actively prosecuted. Case in point: **China Tuna Industry Group**, a Dalian-based supplier of premium tuna to Japan, tried to go public in Hong Kong in September this year. Its draft prospectus, filed in June, stated that in 2006, 2009, 2010 and 2012, the total bigeye catch volume of vessels under the Chinese flag exceeded the catch limits allocated by the Western and Central Pacific Fisheries Commission (WCPFC). However, the prospectus also noted that the WCPFC does not have any sanction mechanisms in place for use against member states that breach their limits.

In other words, China's fishing fleet has repeatedly hauled in more than their allowed tonnage of bigeye tuna, but China has not been penalized. Indeed, no mechanisms even exist for punishment. Why then would China or indeed any other member state bother to comply with the quotas? Better to catch all the fish yourself before others take them, as it were. This is the classic "tragedy of the commons" that all but guarantees total loss for everyone in the end.

As for China Tuna Industry, it withdrew its prospectus after environmental group Greenpeace wrote to the Hong Kong exchange and the Chinese government to express its concern.

Even when said member countries wish to enforce the fishing quotas, they may unable to police their own seas effectively, and thus suffer from pirate fleets fishing illegally in their waters. Such illegal, unreported, unregulated (IUU) fishing is estimated to cost some US$9bn a year globally. Somalia alone is estimated to lose US$300m a year, while

Guinea's loss is estimated at US$100m a year. It is no coincidence that African waters are a favorite target for IUU fishing: Africa is home to many poor coastal countries which have neither an effective coast guard nor large local operators who have already depleted the local fish stocks.

Unlike aquaculture, where the fish are captive and easily monitored throughout their life, fishing in the wild necessarily means that nobody has a really clear idea of just how the fish are doing or how many are left. The result is that overfishing becomes known only after the fact, when the catch has already declined significantly.

Once overfished, a fishery can take decades to recover, effectively putting the current fishery out of business. In the case of the Atlanto-Scandian herring, it took nearly 25 years of almost no fishing for the stock to recover. For slow-maturing deep ocean fish such as the orange roughy, which do not breed until they are at least 20 years old, centuries may be needed for a meaningful recovery.

So that is the backdrop for commercial fishing: an industry with an ignominious past and an uncertain future. What are the implications for investors? If history is any guide, any given fishery runs the risk of becoming overfished and can collapse virtually overnight. This risk means that an investor should demand a very large margin of safety, one that not only compensates for the cost of the ships and fishing quotas, but also for the risk of outright fishery collapse and consequent corporate bankruptcy. Besides requiring a cheap price for the common stock, the investor should be leery of companies with too heavy a debt load, as the fixed cost of servicing the debt may prove overwhelming should the catch decline precipitously.

We will briefly discuss some companies involved in fishing operations.

Copeinca was listed on the Oslo Bors and the Lima Stock Exchange until it was taken private in April this year. The company operates in the Peruvian anchovy fishery. Anchovies and sardines are known to go through boom-bust population cycles. Its 2012 annual report commentary highlights this problem of variable catch; the El Niño weather effect that year resulted in a **40% decline** in the catch versus historical averages. Copeinca was saved only by significant increases in the prices of fishmeal and fish oil, which resulted in increased revenues, but these are of course elements over which it had no control.

Thai Union Frozen is listed on the Stock Exchange of Thailand. It processes and exports frozen and canned seafood, principally tuna (47% of 2013 sales) but also shrimp (25%) and sardine/mackerel (6%). As of 31 December 2013, the company reported some THB 40bn of debt, against earnings before interest, tax, depreciation and amortization (EBITDA) of THB 6.2bn. Financing cost was THB 1.7bn, so debt service coverage was about 3.6 times.

However, interest rates are now at historical lows. If the company pays an average of 6% instead of the current 4%, its financing cost would be THB 2.4bn and debt service coverage would fall to about 2.6 times. If the tuna catch was to fall by half, Group sales could be adversely impacted and it could register a loss, at which time it might have difficulty servicing or refinancing its debt. A 50% decline is conservative as a disaster scenario: as previously noted, several major fisheries have experienced collapses of over 90%, and Copeinca saw a 40% decline in its catch in 2012.

This is not to say that Copeinca and Thai Union Frozen are poorly run, on the contrary both companies are generally quite well regarded. However, the risk inherent in the nature of their operations cannot be denied, and therefore the requirement for a large margin of safety in the balance sheet remains.

Thai Union Frozen stock currently trades at over 24 times 2013 earnings, and at an enterprise value to EBITDA ratio of almost 22 times. Even if the company was debt-free, this price level cannot be said to be a bargain.

Pescanova is a cautionary tale of the danger of too much debt. Listed on Bolsa de Madrid, until recently it was Galicia's second largest company, second only to Inditex of *Zara* fame. Pescanova operates over 50 aquaculture facilities, more than 30 processing factories and a fleet in excess of 100 ships.

However, in March 2013, Pescanova filed for bankruptcy, on account of being unable to reach an agreement with its creditors. Investigations have so far revealed that €3.6bn of debt was hidden in various subsidiaries around the world, away from the auditors.

The company's stock has lost 99% of its market value since the bankruptcy filing. Even the debt is viewed as unrecoverable, with the loans and bonds currently trading in the secondary market at less than 15% of par.

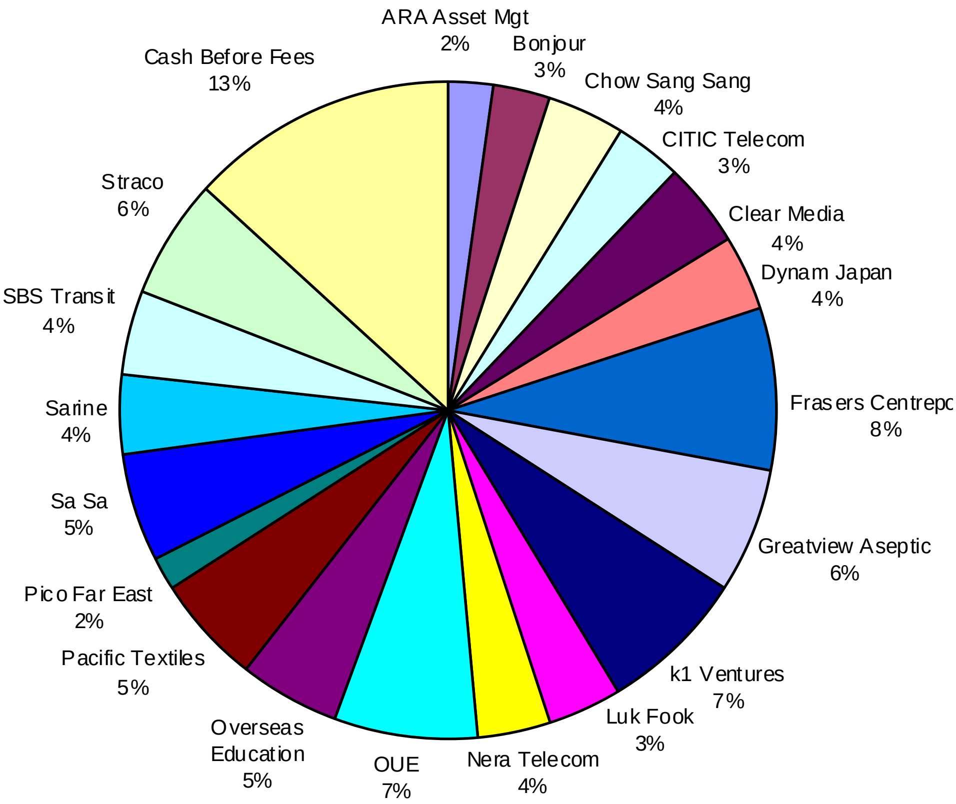
Could investors have sold out in time? Before the problems were discovered, the declared debt at the end of 2011 was €960m. This was over 5 times the company's declared EBITDA and represented a debt/equity ratio of 1.9 times. For a company subject to a real but unquantifiable risk of fish stock collapse, this debt level was already far too high. The 2011 annual report was published in March 2012, one year before the bankruptcy filing. Prudent investors had ample time to sell their shares and recover their money.

In summary, investors in fishing companies should understand the inherent variability of the fish stocks, the risk of overfishing, and the financial strength of the company. Very few companies can survive a 90% decline in volume, and yet such collapses have actually occurred several times before, and continue to occur. Investors should proceed only with great caution, or perhaps not at all.

End

Annex I

Fund Holdings as of 30 Sep 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	109.05	108.58	103.60				**+0.7%**