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LIGHTHOUSE ADVISORS

Keeping Your Capital Safe

Client Newsletter for the period ended 31 December 2014

1. **Foreword**
2. **Market Commentary**
3. **Portfolio Review**
4. **Valuing Cash Payouts**

1. Foreword

Fellow Investors,

Welcome to the Lighthouse Advisors newsletter for December 2014.

This newsletter follows the same format as previous issues. The special topic for this issue is **Valuing Cash Payouts**.

2. Market Commentary

In the US, the jobless rate was 5.7% at the end of January[1]. The last time it was at this level, it was June 2008 and Lehman Brothers was still in business. The US economy is clearly on the mend, and given that the US remains an oil-importing country, the recent halving of oil prices bodes well for it.

Speaking of oil, the decline in oil prices has led many to speculate on the fallout. A decade ago, rising oil prices led many experts to predict a global slowdown; today falling oil prices are leading many experts to predict a global slowdown. One wonders whether these are the same experts as ten years ago.

In Europe, the anemic economic conditions have finally spurred the European Central Bank to copy the US Federal Reserve and launch its own quantitative easing measures[2].

It appears that developed nations are determined to have interest rates as low as possible to encourage borrowing and business expansion, in the hope of reigniting growth. If their currencies decline in value, so much the better to boost exports. Until recently, the Swiss central bank actively suppressed the value of the Swiss franc against the euro, in an attempt to protect Swiss exports of everything from drugs to luxury watches.

Developing nations, on the other hand, are having a rather different sort of problem. Russia's central bank has hiked interest rates to as high as 17% in an effort to slow the steep decline of the rouble, to no avail. Russia is dependent on oil exports, and the fall in oil prices combined with Western sanctions over its actions in the Ukraine have crushed foreign investor confidence. Indeed, Russia's credit rating has now reached "junk" status[3].

Brazil is also having economic troubles. GDP grew just 1.6% in 2014, and the central bank recently raised interest rates to 11.75% in an attempt to fight inflation.

China is not celebrating an economic boom either. The official growth in 2014 was 7.4%, but judging from the numerous profit warnings issued by listed companies across multiple industries, from heavy machinery to power generation, the growth rate in many industries may have been much lower, perhaps even close to zero.

The anti-corruption drive is having its own cooling effect on the Chinese economy, as officials wary of Party censure delay approval of projects. The investigations have ensnared some listed companies as well. The latest to be affected is real estate developer Kaisa Group, whose chairman Kwok Ying-Shing has been detained amid allegations of ties with fallen

[1] *Employment Situation Summary*, **Bureau of Labor Statistics**, 6 February 2015.

[2] *Aggressive ECB Stimulus Ushers In New Era for Europe*, **The Wall Street Journal**, 22 January 2015.

[3] *Russia downgraded to junk status for first time in decade*, **The Guardian**, 26 January 2015.

strongman Zhou Yongkang[4]. Kwok resigned from his post citing "health reasons", triggering a default on Kaisa's bonds. The shares and bonds alike have tumbled in the wake of the default, though the bonds have rallied on recent news that fellow developer Sunac China will take over Kaisa. Kaisa is unlikely to be the last casualty of Xi Jinping's anti-corruption drive.

The "BRIC" hullabaloo from a decade ago is starting to sound rather hollow, just like the now-archaic 1970s notion that corporate Japan would take over the world. Only China has come anywhere close to fulfilling the potential predicted by pundits, and even then time is running out as its population ages.

This brings us back full circle to depending on consumers in developed markets, which today essentially means the US. Europe is too preoccupied with its own internal problems to be of much help on the world economic stage.

What of Asia? The story of the rising domestic consumer still holds true, but investors need to tread cautiously and take growth forecasts with a large helping of salt, especially given the rapid changes in consumer behaviour. People have leapt from having no phone to carrying smartphones, and from making their first purchase in a department store to buying their goods online. Will land lines matter? Will shopping malls matter? The stock market is full of death traps for the unwary.

Amidst the turmoil, valuations have become much more reasonable in recent months, but investing against the macroeconomic headwinds will be a challenge. On the other hand, the low interest rates have spurred a great deal of corporate activity, and now hardly a week passes without a major deal being announced.

It is practically raining special situations at the moment, and it is likely the Fund's exposure to this segment will become much larger this year. This will mean that the Fund's returns will become less correlated with the stock markets, as returns will be driven by company-specific activity rather than general investor sentiment.

The next newsletter will be published for the quarter ended 31 March 2015.

Benjamin Koh
Investment Manager
Lighthouse Advisors
10 February 2015

3. Portfolio Review

As at 31 December 2014, the Net Asset Value (NAV) of the Fund was USD 99.94. Net of all fees, the year-to-date return was -2.9%.

19 securities made up 90% 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

UE E&C is the engineering and construction arm of United Engineers, a conglomerate based in Singapore. United Engineers is divesting its non-core assets in preparation for a likely sale to Thai tycoon Charoen Sirivadhanabhakdi, and UE E&C has been sold to Southern Capital, a mid-market private equity firm, resulting in a mandatory general offer for the company.

The offer price values the company at a small premium to its liquidation value, which is too low given its past track record and obvious ability to continue as a going concern. If the offer is successful, the shares will be compulsorily acquired and the company will be delisted.

If the offer is not successful, the company will remain listed. In such a case, it is likely that excess capital will be returned to shareholders and that the dividend payout ratio will be

[4] *Jiang Faction-Related Real Estate Companies in Hot Water*, **Epoch Times**, 19 December 2014

increased. When Southern Capital eventually divests, minority shareholders will also be able to benefit.

The shares were acquired at a modest premium to the offer price.

Update: In late January Southern Capital announced that it had acquired more than 90% of the shares and intended to compulsorily acquire all the remaining shares. Therefore the Fund will realize a small loss on its holdings.

Divestments

Bonjour Holdings was divested due to 2 negative developments. First, the Occupy Central events have indisputably damaged Hong Kong's reputation as a shopper's paradise. This has clear ramifications on Bonjour's retail business. Indeed, although the total number of visitors from mainland China continues to rise, the per capita spending is falling, implying that these tourists have less spending power and are thus less profitable customers. Bonjour's operating costs will surely rise as it services these lower-yielding tourists.

Second, the beauty salons were sold to HKSE-listed **Town Health** in exchange for Town Health shares, making Bonjour a 7% shareholder of Town Health. Town Health itself already owned 4% of Bonjour, having taken a placement back in 2010. Town Health has not added any notable value throughout this period, and this latest disposal appears to favour Town Health, as Town Health received profitable operating assets, while Bonjour did not receive any cash.

The company claims the disposal will allow it to "consolidate and focus on developing the retail and wholesale of brand name beauty and health-care products business, which is the core business of the Group."

However, pursuant to the disposal, Wilson Ip, the chairman and CEO of Bonjour, will also be appointed as an executive director of Town Health, and as chairman and CEO of the beauty salons business. It seems that Wilson Ip intends to spend considerable time on matters which are *not* the core business of the Group. Given the upcoming challenges that Bonjour faces with respect to mainland Chinese shoppers, this diversion of management attention was unsettling and your manager decided to exit.

Bonjour shares de-rated significantly over the year given the above developments. As a result, the loss on disposal was nearly 50%.

Other Significant Events

Straco purchased the Singapore Flyer, a tourist attraction in Singapore consisting of a giant observation wheel, its supporting Terminal building and a multi-storey carpark. Conceived by German entrepreneur Florian Bollen, the Flyer opened to great fanfare in 2008. However, ticket receipts proved insufficient to service its debt obligations, and it entered receivership in 2013. Your manager's research indicated that Straco's purchase price was very reasonable, and that immediate cost savings could be realized in the short term. More importantly, mid-term projects, if successful, will be able to significantly improve cash flow. In short, the Flyer was a good deal, and potentially a great deal.

Mistakes Made and Lessons Learnt

Bonjour was the most expensive mistake in 2014, as it was a large position that declined by a large percentage. It sold its beauty salons business in August 2014. At that time, the shares were still trading around HKD 1.20. By the time your manager made the decision to sell, the shares had already declined 33%. The lesson here: **when in doubt, sell early.**

Trinity was also a mistake, but as it was a small position its large decline was much less costly to the portfolio. In hindsight your manager should have realized that the challenges it faced were extraordinary, and that even a superstar CEO would have had a hard time turning the business around. It is true that luxury brand **Burberry** did stage an amazing comeback, but that took *19 years* and not one but *two* superstar CEOs in succession to pull it off. Your manager exited Trinity when background checks hinted that the new CEO was unlikely to be a superstar. This precautionary selling helped prevent further losses, but the fact is that the initial investment should not have been made to begin with. The lesson here: **do not invest on hope**.

4. Valuing Cash Payouts

"Dividend investing" is a popular strategy today. At its simplest, it refers to buying the common stocks of companies that pay a dividend. However, given the range of securities available today, it has grown to encompass investing in a variety of instruments, such as preferred stocks, real estate investment trusts, business trusts, and master limited partnerships. Their principal feature, above all else, is regular cash distributions.

Dividend-paying instruments are often valued on the basis of price/earnings ratios or their dividend yield. However, such valuation shortcuts can be completely off the mark when the investment does not follow the standard template of a company that distributes some of its profits as a cash dividend. Such a base case is well understood and need not concern us. What we will examine here, instead, is a situation where cash distributions exceed reported earnings, and the implications thereon.

Keppel Infrastructure Trust (KIT) is listed on the main board of the Singapore Exchange. At present it holds concessions in 2 waste incineration plants (Senoko and Tuas) and 1 water recycling plant (Ulu Pandan).

For the past 4 years, KIT has paid annual cash distributions of 8 cents per unit. However, for the same period KIT's annual earnings ranged from 1.53 cents to 2.54 cents per unit. In other words, it was paying out much more cash than was actually earned. How is this possible, and what does it mean for unitholders?

An examination of the cash flow statement reveals an important clue: the bulk of the cash paid out by KIT did *not* come from profits earned, but rather from "decrease in service concession receivables".

The "service concession receivables" were created when KIT acquired the concessions. Because KIT does not actually own the underlying plant assets, but merely holds *concessions* that will eventually expire, the plant, property and equipment involved in the operations of the 3 plants do *not* belong to KIT. Therefore, KIT's balance sheet does not show the assets of the 3 plants. Instead, because KIT only has rights to the *cash flows* from the plants, it records the estimated total value of these cash flows as "service concession receivables".

Given that KIT does actually receive the cash flows from its concessions, and such cash is in fact paid out, how should KIT be valued?

Since the cash received and paid out is far in excess of reported earnings, using a "sensible" price/earnings ratio would undervalue KIT. On the other hand, using dividend yield assumes that KIT will operate in perpetuity, when this is definitely not the case. The concessions expire in 2024, 2027 and 2034. In the absence of fundraising to buy additional assets or to renew the concessions, the value of KIT in 2034 would clearly be zero. Some of the cash paid out is thus a return of capital and is not an investment return. Therefore neither the price/earnings ratio nor the dividend yield is an appropriate way to value KIT.

The most appropriate method for KIT is the Dividend Discount Model (DDM). It was first published by John Burr Williams in *The Theory of Investment Value* and is widely acknowledged as the theoretical first principle from which all other valuation metrics are derived. However, in practice DDM suffers from significant limitations, notably its sensitivity to estimated future payouts and the discount rate assumed thereon. For KIT, these limitations do not apply.

Over 70% of the cash generated from operations comes from the service concession receivables, which convert to cash at a linear rate until expiry. The remaining 30% comes from actual revenues, which comprise finance income on the service concessions, and operations and maintenance, in the approximate ratio 1:3. Finance income is essentially fixed, while over half of the operations and maintenance revenue consists of fixed payments. Taken together, about 90% of the cash received and paid out by KIT is fixed in nature, so as a first approximation the future cash flows can be modeled as being constant, or increasing at a modest rate in line with GDP, up until expiry.

The second question is the discount rate that should be used. Since the concessions ultimately rely on contracts with the Singapore government, the discount rate should be pegged to the risk-free rate in Singapore, in other words the Singapore government bond rate. The follow-on question would then be which maturity one should use. The concessions expire in 9, 12 and 19 years. However, the Senoko concession accounted for over 65% of the total concession value at IPO in 2010, and it expires in 2024 i.e. 9 years. On a value-weighted basis, the reference risk-free rate should therefore be a blend of the 10-year and the 15-year bond rate. The 10-year rate is about 1.9%, and the 15-year rate is about 2.2%. This suggests a risk-free reference rate of 2% for KIT.

Since KIT is not, in fact, the Singapore government, but merely a channel through which the investor can receive payments from the Singapore government, a premium over the risk-free rate is warranted. A 2% premium would not be unreasonable, giving us a 4% discount rate to apply to the future cash flows that KIT will receive and pay out.

The remaining valuation work is simple data entry and is left as an exercise to the interested reader. Using a 2% growth rate and a 4% discount rate, one obtains a Net Present Value for KIT of about $0.93, not far from the trading price of about $1.075. On the other hand, KIT appears overvalued based on its price/earnings ratio of over 50 times, yet it also appears undervalued based on its yield of 7.5%. Both metrics cannot be correct at the same time, and in this case they are actually both wrong. KIT is correctly valued when using DDM, assuming a 4% discount rate or thereabouts.

The point here is that price/earnings ratios and dividend yields are crude methods that can easily lead one astray, and that it behooves the active investor to be able to use other valuation methods. A carpenter is expected to carry a full toolbox when going about his work; an active investor working to uncover suitable investments should expect no less of himself.

End

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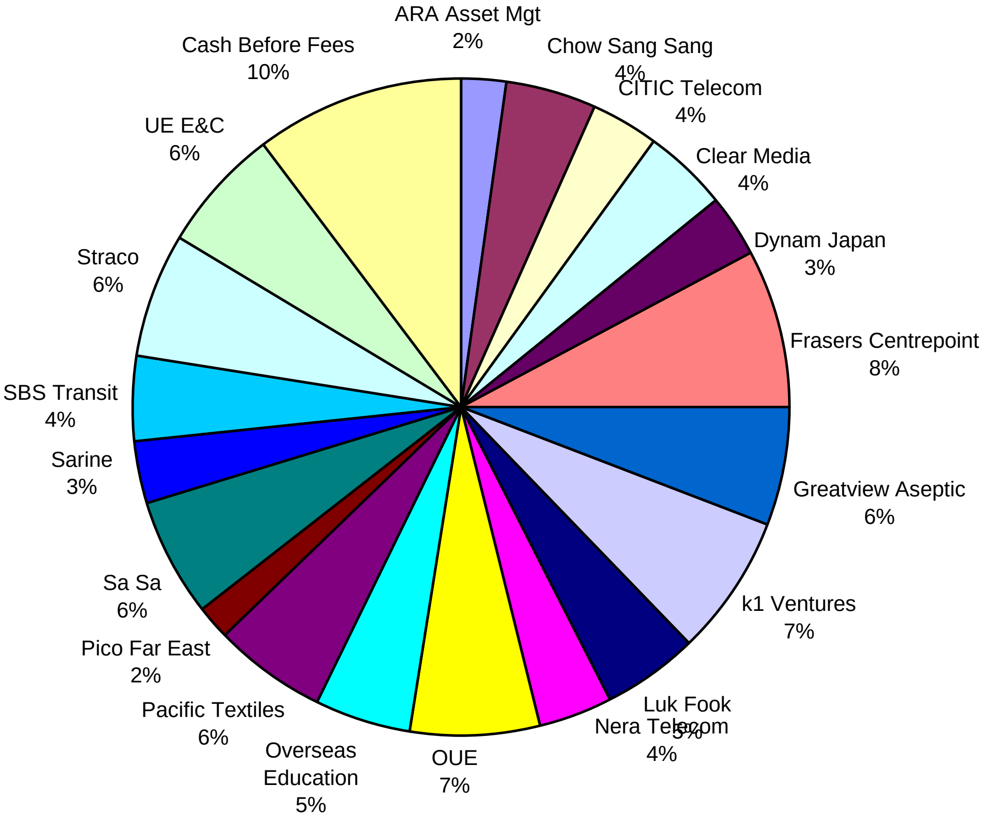
Annex I

Fund Holdings as of 31 Dec 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	103.91	101.87	99.94	**-2.9%**

Updated 10 February 2015