LIGHTHOUSE ADVISORS
Keeping Your Capital Safe

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 31 March 2015

1. Foreword

Fellow Investors,

Welcome to the Lighthouse Advisors newsletter for March 2015.

This newsletter follows the same format as previous issues. The special topic for this issue is **Non-Core Assets**.

2. Market Commentary

In the US, the jobless rate was 5.5% at the end of March[1]. The economy is doing fine, but the Federal Reserve has not shown any desire to increase interest rates, which suggests that "free" money will continue to pour into both the housing and equity markets. Eventually, when money is no longer free, many investors (speculators?) will be forced to sell, and there will not be a happy ending.

Many have written about the current negative interest rates. What is not so widely appreciated is *why* the negative rates persist. Hedge fund manager David Einhorn of Greenlight Capital recently presented at Grant's Investment Conference, where he argued that the EU Solvency II Directive was largely responsible.

Under Solvency II, to encourage insurers to hold long term assets like bonds to match their long term liabilities, government bonds are deemed less risky than cash and attract a *negative* capital charge. However, when yields are negative, government bonds are indisputably *more* risky than simply holding cash, since cash holds its nominal value, while the bonds are guaranteed to return less than their cost. Yet insurers cannot simply sell the bonds and hold cash, because the increased capital charge would force them to sell other assets or raise fresh equity in order to remain in compliance with Solvency II.

It is unlikely the regulators envisioned the possibility of negative yields when they codified Solvency II, so the insurers appear to be suffering from a rather expensive case of unintended consequences.

In China, the stock market has, for want of a better word, gone "bonkers". The Shanghai Composite Index has doubled in the last 12 months. The index itself does not appear overly expensive at about 15 times forward earnings, but this is because of the large weighting given to banks, whose shares have been held down by concerns over non-performing loans. Median valuations offer cause for concern: in Shanghai the median is 30 times earnings, while in Shenzhen the median is 39 times.

The clamour by retail investors for a piece of the action has led Bloomberg News to dub the situation in China "Amateur Hour"[2] where shares are considered cheap when they sell for low absolute prices, regardless of what they represent in terms of earnings, book value or any other financial measure of a company.

Some have attributed such attitudes to mistrust of the stock market due to accounting scandals – after all, if financial statements cannot be trusted, then everyone is by definition gambling, and buying for any one reason is as good as another. Others blame ignorance and

[1] *Employment Situation Summary*, **Bureau of Labor Statistics**, 3 April 2015.

[2] *It's Amateur Hour in the Booming Chinese Stock Market*, **Bloomberg News**, 12 January 2015.

point to a recent survey by China's Southwestern University of Finance and Economics, which revealed that two-thirds of the 4,000 new investors surveyed did not complete high school.

Besides valuations, another measure of a bubble is money borrowed to buy shares, or margin financing. A glance at 4 Chinese stockbrokers, CITIC Securities, GF Securities, Haitong Securities, and China Galaxy Securities, shows that total outstanding margin loans, including repurchase agreements, increased from RMB 135bn on 31 Dec 2013 to RMB 380bn on 31 Dec 2014. The margin book essentially tripled. Aggregate leverage at the 4 brokers, measured as total assets divided by total equity, increased from 294% to 508%.

Can the brokers lend more money? Certainly, especially if they can issue debt or issue new shares for cash. In fact, in April 2015, Haitong Securities issued USD 670m of bonds, while GF Securities issued RMB 2bn of bonds and issued 2bn shares for HKD 24bn. Undoubtedly, most of these proceeds will be used for margin financing.

But at some point, enough leveraged investors will want to take some profits off the table that the initial spurt of selling will cascade into an avalanche that will bury many victims.

The Hong Kong stock market has recently spiked as well. The Chinese government recently allowed fund managers in mainland China to buy Hong Kong shares, with the result that the relatively cheaper shares in Hong Kong have proven irresistible. Many of the best performers have been recognizable companies with a strong market position and already-expensive shares, but compared with their peers in Shanghai or Shenzhen they seem like a real bargain.

A case in point: Sinopharm is China's largest drug distributor. It trades for about 27 times earnings, a rich valuation that is perhaps justified by its strong growth prospects. A smaller rival, Jointown Pharmaceutical, trades in Shenzhen for 71 times earnings. Compared with Jointown, Sinopharm's revenues are more than 5 times larger, its margins are higher, and yet it trades at less than half the valuation of Jointown. On a *relative* basis Sinopharm is clearly a superior investment to Jointown. But on an *absolute* basis it is not so clear that the investor will necessarily do very well with Sinopharm shares.

Is it different this time? If we make the reasonable assumption that human behaviour has remained fundamentally unchanged since financial markets were created, then today's free money and frothy markets must eventually end badly.

Of course, nobody knows for sure when the "Great Wall of Money" will run out. It could be triggered by a revival in the Chinese property market which sucks money out of the stock market, a seemingly-innocent change in regulations that makes other investments more attractive, a curb on margin financing, an increase in interest rates, or something else altogether. As investors, we can only prepare for the worst and hope for the best.

For now, there does not seem to be a stock market bubble in Hong Kong, but continued strong gains could quickly change that assessment.

The Fund's exposure to workouts, or special situation investments, continues to be at historic highs. While this means the Fund will not fully participate in any "irrational exuberance", it will also be somewhat insulated from a "bear ambush". Short-term returns may not appear satisfactory in the light of the recent strong gains in China and Hong Kong, but over a 3-5 year period, the compounded rate of return from the realization of the workouts should be highly satisfactory.

The next newsletter will be published for the quarter ended 30 June 2015.

Benjamin Koh
Investment Manager
Lighthouse Advisors
1 May 2015

3. Portfolio Review

As at 31 March 2015, the Net Asset Value (NAV) of the Fund was USD 97.74. Net of all fees, the year-to-date return was -2.2%.

19 securities made up 79% 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

Sunningdale Tech is a manufacturer of plastic components for the automotive, consumer electronics and healthcare industries. It was formed from the 2005 merger of Sunningdale Precision and Tech Group. The company has spent the last several years restructuring its operations. In late 2014 it acquired another plastics company, First Engineering. The combined company has minimal overlap in facilities and products, and sales will be about 33% higher post-deal. The purchase price was 4.7 times EBITDA.

The plastics manufacturing business is not easy. Good technical capabilities are needed to deliver high-precision products in large volumes, yet suppliers receive low selling prices and possess little bargaining power amid intense price competition. Over time, as the market consolidates, pricing power will improve.

In the meantime, the shares represent a bargain. They were acquired at about 9 times earnings, two-thirds of net tangible assets and a 4% yield. EV / EBITDA of the combined company was 3.4x. Free cash flow is strong: at current levels the company will be debt-free in two years, which will allow an increased dividend, another acquisition, or both.

Divestments

UE E&C was sold as Southern Capital had acquired more than 90% of the shares and intended to compulsorily acquire all the remaining shares. The loss on divestment was about 2%.

Other Significant Events

OUE has sold the Crowne Plaza Changi Airport to OUE Hospitality REIT for $290m in cash. The gain on divestment was $42m or 5 cents per share. This is part of the asset recycling that your manager foresaw when the OUE shares were first purchased. The extension to the hotel will also be sold to the REIT upon completion, which will yield a further $71m of gains, equivalent to 8 cents per share.

4. Non-Core Assets

"Non-Core Assets" refers to assets held by a company which are not used in its main lines of business. They may be legacy assets left over from discontinued businesses, but more often arise from opportunistic investments by management. Examples include commercial properties bought for self-use that have since appreciated in value, and financial assets acquired during distress in the capital markets.

In theory, non-core assets can be sold for cash that can be returned to shareholders or reinvested to grow the core business. Companies with significant non-core assets therefore have potential for abnormal returns.

However, in practice it is important to understand the role that the so-called non-core assets play in the company. Even if the non-core assets are monetized, the proceeds may not be returned to shareholders. Or, upon further analysis, the non-core assets may not represent hidden value at all, but actually form part of the permanent assets of the company.

Two companies will be covered in this article.

K. Wah International is a Hong Kong-listed property developer active in Hong Kong and mainland China. What makes K. Wah interesting to many investors is that it currently holds 162m shares in **Galaxy Entertainment Group**, which operates casinos in Macau. Galaxy is listed on the Hong Kong Exchange. It was created in 2005 when K. Wah injected its 98% economic interest in Galaxy Casino S.A. into K. Wah Construction Materials, which then changed its name to Galaxy Entertainment.

K. Wah received cash, interest-bearing notes and shares in Galaxy Entertainment in the deal. After distributing Galaxy shares to its shareholders as a special dividend, K. Wah was left with 615m shares, a stake of 18.7%.

K. Wah subsequently sold 452m shares of Galaxy to a private equity fund advised by Permira, leaving it with the current block of 162m shares. K. Wah paid out another special dividend, but this time only half the profits on disposal, or 20% of the proceeds, were paid out, while the rest went to fund the core property development business.

Is is true that K. Wah shareholders who received the Galaxy shares in the distribution and held on to them would have done very well, even after the large decline in 2014. Galaxy shares traded at HKD 4.40 at the end of 2005, whereas at the end of 2014 they traded at HKD 43.65, a gain of nearly 900%.

It is also true that the second sale of Galaxy shares did not go so well for K. Wah investors, as the special dividend was considerably smaller.

Today the remaining stake in Galaxy is smaller still, so the impact from any sale will be further reduced.

Nonetheless, some K. Wah shareholders still believe that not only will the remaining shares in Galaxy be sold off at a good price, but that most or all of the proceeds will be paid out to them. They point to the fact that in the past, the market value of the 3.8% stake in Galaxy was more than the market value of K. Wah, implying that an investor was simply buying shares in Galaxy and getting the rest of K. Wah for free.

Hope springs eternal in the human breast;
Man never is, but always to be blessed;
The soul, uneasy and confined from home;
Rests and expatiates in a life to come.

– Alexander Pope, An Essay on Man

But… *free* is a dangerous word in the world of investing. In this case a deeper level of analysis was required, namely whether the Galaxy shares themselves were a sound investment at that point. Certainly, it would have been more sensible to buy K. Wah instead of Galaxy at that point, since the investor would receive K. Wah's real estate for free, but the bigger question was whether Galaxy was a worthwhile purchase on its own. If it was not, then buying K. Wah was merely **a better way to make a bad investment**, which would lessen but not negate the folly of the original decision to own Galaxy shares.

Indeed, during 2014, Galaxy shares fell from HKD 69.55 to HKD 43.65, a decline of 37%. K. Wah fell from HKD 4.70 to HKD 4.11, a drop of 13%. A shareholder in K. Wah did, in fact, do better than a shareholder in Galaxy, but clearly, instead of buying (a) Galaxy; or (b) K. Wah, the correct choice was (c) **none of the above**.

Haw Par Corporation is a holding company listed in Singapore. It has 4 main business segments: healthcare, leisure, property, and investments. The investments segment consists of passive stakes in various listed entities.

At first glance, the investments are non-core, as Haw Par does not own enough shares to control them. Tantalizingly, the market value of the 3 largest investments (**UOB**, **UOL** and **UIC**) totals $2.26bn, which exceeds Haw Par's own market capitalisation of $1.92bn.

Essentially, if an investor was willing to own shares in UOB, UOL and UIC in the same proportion as Haw Par, by buying shares in Haw Par, for the same amount of money he would obtain the shares in these 3 companies, plus all the other businesses in healthcare, leisure and property for free. Haw Par reported $2.81bn of shareholder equity on 31 Dec 2014. Subtracting all the available-for-sale investments of $2.31bn leaves $500m of assets available for “free”.

Here again we have that dangerous word *free*. *Can* an investor actually obtain value from the “free” assets? It is true that Haw Par *could* sell the 3 investments and pay out the proceeds. In theory, if a shareholder could spend $1.92bn to buy Haw Par, that shareholder could immediately sell the investments for $2.26bn. He would book a $340m profit and still own assets with a book value of $500m. $840m of profits against an investment of $1.92bn would be a fat 44% margin.

Unfortunately, the theoretical transaction described above is impossible in reality. The reason is simple: Haw Par’s 69.6m shares in UOB have a more important purpose than simply being an investment. In fact, **the UOB shares are more important than all the rest of Haw Par put together**. Here is why:

UOB is the crown jewel in the Wee family empire. It is absolutely essential for the Wees that they retain control of UOB. Yet, the 2014 annual report of UOB shows that the Wees do not have an absolute majority stake. In fact, Patriarch Wee Cho Yaw’s deemed interest only reaches 17.9%. This still makes him the single largest shareholder and allows him to control UOB. But Wee Cho Yaw’s direct holdings are only 1.2%, and his family vehicle Wee Investments owns just 7.7%. Where does the rest of the deemed interest come from?

Haw Par is part of the answer. Haw Par’s 69.6m UOB shares amount to 4.4% of UOB. Family vehicles Wee Investments and Supreme Island own 27% and 5.5% respectively in Haw Par, while UOB itself owns 9.9%. Together, these blocks allow Wee Cho Yaw to control Haw Par – and vote *its* 4.4% of UOB shares in his favour as needed.

It therefore becomes clear that the shares in UOB will not be sold or distributed under any conceivable circumstances. If the UOB shares were distributed to Haw Par shareholders, Wee Cho Yaw would end up with only one-third of the UOB shares, and crucially, only one third of the votes.

A similar situation exists at UOL, where C Y Wee & Company owns 14%, Wee Investments owns 13%, and UOB owns 8%. Haw Par owns 5.4% of UOL, a very useful voting block. Together, they allow Wee Cho Yaw to control UOL. UOL itself also owns 2.3% of UOB, therefore making control of UOL necessary to ensure it votes *its* 2.3% of UOB shares in Wee Cho Yaw’s favour.

Of course, UOL’s UOB shares are also not for sale, despite them being “non-core” to UOL’s property development business. The UOB shares are worth $900m, against UOL’s market capitalisation of $6.3bn. This is $900m of value that will never be unlocked.

In the case of UIC, Haw Par owns 4.9% of UIC. This, together with the 41.6% block held by UOL, allows Wee Cho Yaw to control UIC.

Clearly, despite being described as “available for sale investments”, the stakes in UOB, UOL and UIC are in fact all parts of larger blocks of shares used to control these companies. So how should a minority investor value them, and by extension Haw Par?

It should now be obvious that price-to-book and “breakup value” are absolutely the wrong ways to value Haw Par, since, as explained above, the chances of it being broken up are essentially nil. Investors buying in the hope that the investment portfolio will some day be liquidated and paid out should be prepared to be disappointed, because, as Neil Sedaka sang back in 1962, “Breaking Up Is Hard To Do”.

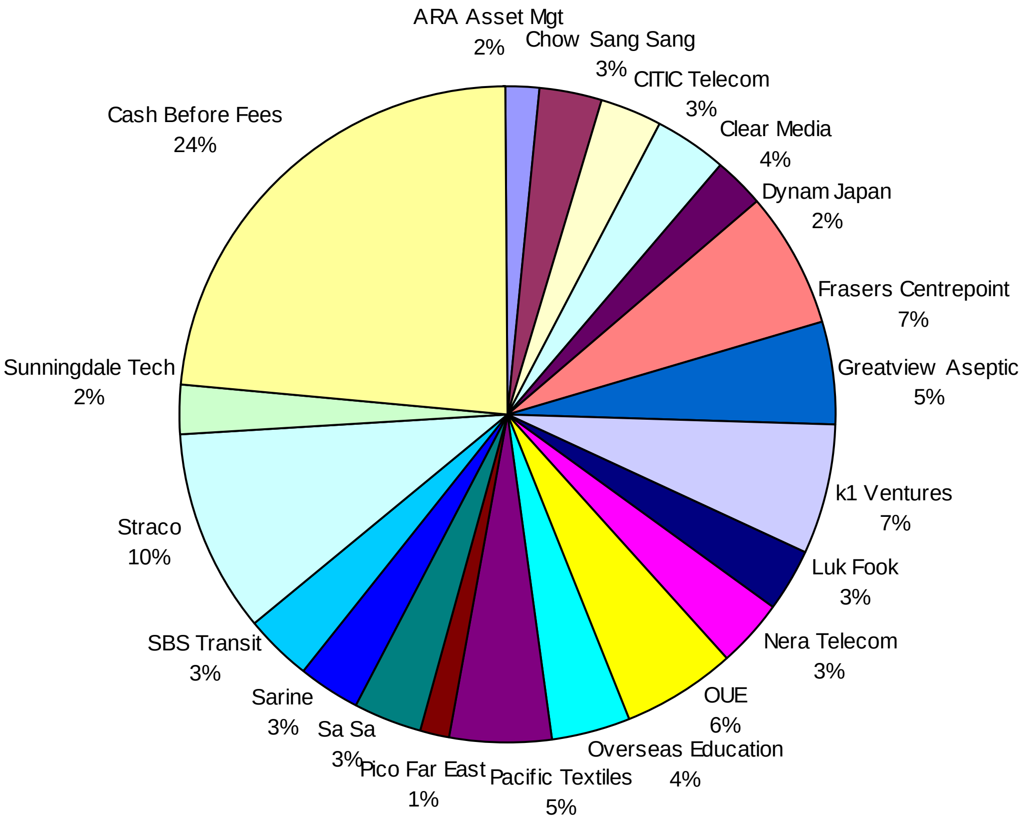
There is however a simple method to value Haw Par: Haw Par has been passing on the bulk of the dividends it receives to its own shareholders, so Haw Par can actually be valued on the basis of dividend yield. The price-to-earnings ratio is another way, since most of Haw Par’s earnings are in fact the dividends it receives on these assets.

In conclusion, non-core assets are not simply “free” money. Even if sold, the cash may not be returned to shareholders, and sometimes the non-core assets are in fact core assets that will not be sold. It is not difficult to identify companies that carry significant non-core assets on their balance sheets. It is considerably more difficult to identify whether, how and when a passive minority investor is going to benefit from such assets.

End

Annex I

Fund Holdings as of 31 Mar 2015



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%**
2015	97.97	98.16	97.74										**-2.2%**