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 2015

1. **Foreword**
2. **Market Commentary**
3. **Portfolio Review**
4. **Roads to Riches**

1. Foreword

Fellow Investors,

Welcome to the Lighthouse Advisors newsletter for September 2015.

This newsletter follows the same format as previous issues. The special topic for this issue is **Roads to Riches**.

2. Market Commentary

In the US, the Federal Reserve has cried wolf again, threatening to raise rates but still refusing to do so[1]. The "positive carry" for aggressive investors and speculators (is there a difference?) continues, with a recent auction of 3-month T-bills being sold at a yield of exactly zero[2].

As mentioned in the March newsletter, this points to inelastic demand from financial institutions who are forced to hold such instruments by regulatory rules. Should said regulations change to become more sensible, this trade could unwind at great speed. Anyone voluntarily participating in the US government debt market should tread with extreme caution.

In China, the bear market continues. On 30 September, the Shanghai Composite closed at 3,053, some 41% off its 12 June peak of 5,166. Stock market sentiment is only now starting to reflect the muted economic outlook in China. While many who follow the Chinese government's latest pronouncements may believe that China will grow at 6.8% this year, those who analyze individual companies have reason to be skeptical.

State-owned companies in coal, steel, cement and shipping are all facing difficulties. It is hard to imagine that the private sector is going all out and offsetting the decline in these important heavy industries.

In a telling sign that China is in fact having a hard landing, the largest state-owned coal miner in northeastern China is laying off 40% of its workforce[3]. That amounts to 100,000 workers. As state-owned companies are presumably reluctant to fire workers, the situation must be dire indeed. Meanwhile, Cosco Group and China Shipping Group are in talks to merge after years of poor operating results from both sides[4].

A glance at the recent results of some listed Chinese companies involved in heavy industry is sobering. Below is a table summarizing some data for 2014 and 2015.

Cement Sales Value	**2014 vs. 2013**	**1H15 vs. 1H14**
China National Building Material	3.7%	-13.4%
Sinoma	6.1%	-9.1%
Anhui Conch	9.9%	-16.0%
BBMG	-8.0%	-12.1%
Steel Sales Value	**2014 vs. 2013**	**1H15 vs. 1H14**
Baoshan Iron & Steel	-1.2%	-17.3%
Hebei Iron & Steel	-10.9%	-16.4%
Wuhan Iron & Steel	-2.1%	-30.6%
Coal Sales Volume	**2014 vs. 2013**	**9M15 vs. 9M14**
China Shenhua	-12.4%	-18.3%

[1] *Fed Keeps December Rate Hike in Play*, **Wall Street Journal**, 28 October 2015

[2] *Yield of 0% a First at 3-Month Treasury-Bill Sale*, **Wall Street Journal**, 5 October 2015

[3] *Coal Miner in Northeast Plans to Slash Workforce by 100,000*, **Caixin Online**, 24 September 2015

[4] *Possible merger of Cosco Group-China Shipping Group may not bring much joy*, **South China Morning Post**, 1 September 2015

China Coal Energy	-2.7%	-12.1%
Heavy Equipment Sales Value	**2014 vs. 2013**	**1H15 vs. 1H14**
SANY Heavy Industry	-18.7%	-30.5%
Zoomlion Heavy Industry	-32.9%	-16.1%
Weichai Power	36.6%	6.9%
Sinotruk	7.9%	-14.9%
Domestic Power Generation MWh	**2014 vs. 2013**	**1H15 vs. 1H14**
Huaneng Power International	-7.3%	-1.6% (adj. for acq.)
Huadian Power International	2.7%	-7.3%
Datang International Power	-1.6%	-4.3%

While the result at each company differs, in aggregate, the jigsaw pieces form a clear picture: from the standpoint of heavy industry, China's GDP growth in 2014 was already weak, and so far in 2015 GDP growth is *negative*.

China's much-touted 一带一路 ("One Belt One Road") is a grand plan to connect China to Europe by land and to Southeast Asia and Africa by sea. It was announced in late 2013 and has caught on with many members of the investing public who hope, or more accurately, *imagine* that the accompanying construction work to realize the plan will drive sales and profits at companies involved in infrastructure, viz. steel, cement, heavy machinery and transportation. But while it is an easy catchphrase to remember, quantifying its impact is much harder.

For starters, the incremental demand may not be enough to use up the surplus capacity. Other observers have also noted that some of the projects under "One Belt One Road" had already been proposed earlier and should not be double-counted, so the project is somewhat smaller than announced.

One might also wonder: if the "One Belt One Road" plan will do such wonders for China, why are we not seeing any effects now? It has been over 2 years since the first official announcement, and precious little seems to have come of it. Indeed, a cynic might conclude that "One Belt One Road" is merely a fancy name for long-term plans that the Chinese government had already set in motion prior to the announcement. In other words, <u>there may be little or no incremental construction demand at all</u>.

So, given the recent sub-par results in heavy industry, and adding some healthy skepticism about the effect of "One Belt, One Road", it seems only sensible to infer that, official numbers notwithstanding, China's growth rate in 2015 will in reality be much lower than 6.8%, and may actually be negative.

Skeptics may point out that China may still do fine off the informal economy, where transactions are conducted in cash and go unrecorded. However, this informal economy is under siege from the Chinese government's anti-corruption drive. This is evident from the collapse in sales of luxury watches.

Most Chinese officials are men. When they get a bribe they usually buy (i) a watch; (ii) a suit; and (iii) a pair of shoes. Surplus bribes (is there such a thing?) may be channeled to the wife or mistress, who may then spend it on gold and jewellery. But with the increased scrutiny, it is no surprise that conspicuous consumption has fallen out of favour.

Below is a short summary of some Hong Kong-listed luxury watch retailers' results:

Luxury Watch Sales Value	**Year End**	**FY15 vs. FY14**	**2HFY15 vs. 2HFY14**
Oriental Watch	31 Mar	-10.6%	-10.7%
Sincere Watch HK	31 Mar	-9.0%	-14.5%
		2014 vs. 2013	**1H15 vs. 1H14**
Emperor Watch & Jewellery	31 Dec	-10.6%	-21.1%

With heavy industry on the wane, and the informal sector shrinking, the short-to-medium term outlook in China is increasingly hazy.

Speaking of haze, in February 2015 穹顶之下 ("Under The Dome") was released online. A documentary narrated by investigative journalist Chai Jing, it chronicles her journey to find out just why China's smog problem seems to be getting worse despite the more stringent environmental regulations.

The conclusion, which should be no surprise to those who actually run factories in China, was that China's environmental regulations are routinely ignored due to weak or non-existent enforcement. Since 2004, when the laws were enacted, there have been exactly zero cases of prosecution for flouting the emissions standards, so anyone who complies would face higher costs than the competition and go bust. In Chai Jing's own words: 不执法的结果就是逼别人作假 ("not enforcing the law forces people to cheat").

What does this mean for investors? For one, because the smog problem has become so visible that it is now impossible to deny, the Chinese government may actually begin to enforce its own laws. When that happens, it is obvious that polluters will face higher costs and thus lower profits. Heavy industry is the obvious target, so for starters it would be prudent for investors to avoid steel producers, cement makers, coal-fired power plant operators, and truck manufacturers.

Given this gloomy data, does this leave investors in China anywhere to put their money? Yes. **The middle class is real**. At companies catering to the mass market, from Alibaba to Wumart, revenues continue to rise. Share prices do not always reflect this reality. Indeed, the owners of Wumart have just proposed to take the company private at a significant premium to the last traded price. Prior to the announcement, Wumart's share price had fallen 50% this year. It seems likely that there will be similar transactions in the months to come if the stock market continues to underperform the real world. Given the more-sensible valuations already prevailing in Hong Kong, it seems promising as a fishing ground for the enterprising investor.

Of course, when mentioning haze, the elephant in the room is the burning forests in Indonesia. Schools in Singapore and Malaysia have been forced to close on several days when the air pollution reached "very unhealthy" levels. Indonesia's own Pollutant Standard Index indicates "hazardous" for readings beyond 350; at ground zero in Palangkraya, Kalimantan, it was *1,990* on September 22. It is estimated that about 1.7m hectares of forest have been destroyed so far. Over 500,000 people in Indonesia have been diagnosed with respiratory illnesses since the fires began.

Given the international outcry and widespread criticism, perhaps this year the Indonesian government will finally get serious about stopping the haze. But then, the haze has been around for decades. The oil palm and paper companies who grow their crops on the burnt land seem to have funds aplenty to keep enforcement at bay. They have certainly outlasted every politician to date. Sufferers waiting for rain to come and put out the fires must be patient; this year the El Niño effect is expected to delay the onset of wet weather, so the haze may persist into 2016.

As for the Fund, following the last few months of declines in the markets, investment opportunities have begun to surface. The Fund is now actively deploying its cash. Your manager expects that, given the attractive purchase prices, these recent investments are likely to produce good results over the medium and long term. The next newsletter will be published for the quarter ended 31 December 2015.

Benjamin Koh
Investment Manager
Lighthouse Advisors
30 October 2015

3. Portfolio Review

As at 30 September 2015, the Net Asset Value (NAV) of the Fund was USD 84.17. Net of all fees, the year-to-date return was -15.8%.

22 securities made up 89.0% 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.

As this has been a particularly bad quarter for the Fund, it warrants additional discussion. The quarter's top 5 losers are shown below.

Stock	30 Sep vs. 30 Jun
Dongpeng	-34.5%
CIMC Enric	-32.9%
Pico Far East	-27.4%
Sarine	-24.4%
Overseas Education	-25.3%

Dongpeng reported a 1.8% increase in sales for 1H15, with profits increasing 28.9%. Adjusted for government grants, profits increased 25.2%. It seems to have been unfairly sold down.

CIMC Enric and **Sarine** are discussed below under "Other Significant Events".

Overseas Education has been hit by declining enrollments due to 2 factors: parents have pulled their young children out to avoid commuting to the new campus, and many expatriate families are being recalled as foreign companies implement cost cuts in the face of a weak economy back home.

Pico Far East reported that for the half-year ended 30 April, sales increased 13.7% with profits rising 25.6%. It, too, appears to have been unfairly sold down.

Your manager remains confident in the long-term prospects of the companies in the Fund's portfolio and has added money to the Fund. While the short-term outlook remains uncertain, longer-term, things look good.

<u>New Investments</u>

CITIC Telecom was repurchased in the wake of further developments after the Fund exited.

In August 2015, the company proposed to acquire 39% of CITIC Networks from its ultimate parent company CITIC Group.

CITIC Networks owns and operates a fibre optic network in China stretching over 24,000 km with over 32 points of presence. CITIC Telecom intends to leverage CITIC Networks to enter the telecommunications infrastructure business. Internet usage is growing rapidly worldwide, and China is no exception. Managed properly, CITIC Networks could become a major player in the internet bandwidth business.

After the Fund sold off its initial holdings, the stock fell about 33% in the market sell-off. The Fund repurchased the shares for about 12 times trailing earnings and a yield of 4.4%, giving no value to the proposed acquisition of the stake in CITIC Networks.

Fu Yu is a manufacturer of plastic injection moulded components for the automotive and consumer electronics industries. The company suffered losses in 2006-2009 and again in 2011 and 2012. Some of its troubles can be traced to one of its founders, Lui Choon Hay, who helped his daughter set up a rival firm which competed for business with Fu Yu. Lui has since left the company and sold his shares.

The 3 remaining founders have managed to turn the company around, and in July 2015 the company conducted a reduction of capital to wipe out accumulated losses. It also resumed paying dividends. This is a good sign that the management is confident that the company has been "right-sized" and that operations are now stable enough to support dividends.

Fu Yu is fundamentally a smaller version of Sunningdale Tech, another Fund holding. The shares, like those of Sunningdale Tech, are a bargain. The shares were bought for 8 times earnings, with a 1.6% yield. Price to book was 0.6x and the EV/EBITDA multiple was 1.3x.

On 1 September 2015, Chosen Holdings, another plastic manufacturer, was the subject of a general offer by Shaw Kwei & Partners, a private equity firm. The price represented 5.7x EV/EBITDA and 1x book value. This sets an important benchmark for any future buyout of Fu Yu and Sunningdale Tech.

IT Limited is a fashion retailer based in Hong Kong with operations in China and Japan. Brothers Sham Kar Wai and Sham Kin Wai founded the business in 1988 and built it up into Hong Kong's largest multi-label retailer. In-house brands comprise 58% of sales, with international and licensed brands making up the balance. An acquisition in 2011 gave the group the *Bathing Ape* brand, which drives sales in Japan, a key market that accounts for only 6% of sales, but generates 20% of EBITDA. The Group has just under 800 stores, with some 15% run by franchisees. It also has a 50/50 joint venture with French department store operator Galeries Lafayette which operates a 40,000 sqm store in Beijing.

Like many Hong Kong retailers, IT was hit by disruptions from the "Occupy Central" event in late 2014. Going forward, there will also be fewer Chinese tourists visiting Hong Kong. However, the Chinese daytrippers whose visits are being restricted are not IT's target market. IT targets the fashion-conscious middle-class who are shopping for themselves. Thus far, this strategy has avoided both the cut-throat competition in the mass-market segment and the sales collapse in the luxury segment.

China now accounts for about 40% of sales and 35% of EBITDA. These proportions will increase over time, as the Group's sales in China are growing faster than sales in Hong Kong and Japan, its other key markets.

The shares were bought for 10 times trailing earnings, with a 4% yield. Price to book value was 1.0x, while in terms of EV/EBITDA, the multiple was about 3x.

Lian Beng is a construction and property development company based in Singapore. In recent years, the Group has plowed its earnings into income-generating real estate.

Its 2 largest investment property assets are purpose-built foreign worker dormitories. Both are co-owned with Centurion Group, Singapore's largest worker dormitory operator. The first dormitory, Westlite Mandai, is 55%-owned. Completed in October 2013, it holds 6,290 beds. Occupancy is near 100%. The second dormitory is 49%-owned and is still under construction. There will be 7,900 beds and a 3,000 sqm training centre. It will serve those who work on nearby Jurong Island. It is also expected to operate at or near full capacity when completed in mid-2016.

The outlook for the construction segment is weak, as the latest order book is only half of what it was one year ago and projected margins on the winning bids are thin. Group earnings this year will be driven by the property development segment, as most of the projects are almost 100% sold. In any case, the strength of the Group's balance sheet will allow it to ride out the downturn. Cash on hand, investment securities and investment properties comfortably exceed debt.

The shares were bought for 4.6 times trailing earnings, with a 6% yield. Price to book was below 0.6x.

"Surplus assets" not needed in operations, such as investment securities, investment properties, and a stake in an office building, added up to 140% of the company's market capitalization, implying that the still-profitable construction and property development businesses were being given away.

Divestments

Dynam Japan was sold after your manager visited the company in Japan. After further discussions with company management, your manager concluded that the company was unlikely to be able to grow faster than the overall market was shrinking, due to unfavorable demographic trends.

Dynam's customers are mainly middle-aged and older residents in rural areas. These areas are being depopulated as young Japanese move to the major cities. Further more, many of the elderly Japanese in rural areas are retirees dependent on government pensions. Japan's large budget deficit is forcing an increase in the consumption tax as an alternative to directly reducing pension payouts. The effect is to reduce the purchasing power of pensioners, which in turn curtails their spending at pachinko halls. Therefore, the Group's customer base is shrinking over time. This has major negative implications for revenues, earnings, and cash flow.

Additionally, the company has touted itself to investors as the most obvious local partner for foreign casino operators looking to invest into Japan. However, there is no guarantee that the Casino Bill will be passed. Even if it is, if the intent is to promote a few large casino projects, these will be near major metropolitan areas such as Tokyo or Osaka. The Group operates in rural areas and will be of little help to foreign casino operators in an urban project.

The Group's own proposed site for a casino development, in Yamaguchi prefecture, will only be a contender if the Bill promotes a large number of small casinos, in which case Yamaguchi prefecture would have to bid for a project, win, and then appoint Dynam to operate a casino. Even then, execution risks remain, as the Group would need a few years to design and construct the casino. It all seems to be a bridge too far. Too many things have to go right for such a project to work out.

After including dividends received, the loss on divestment was about 30%.

<u>Other Significant Events</u>

CIMC Enric announced a profit warning for the first half of 2015. This was attributed primarily to the decline in the price of oil, which has made natural gas less competitive, reducing demand for the Group's natural gas-related equipment. There was also a one-off reversal of tax which inflated profits in the previous corresponding period. The Chinese government is widely expected to cut natural gas prices by year-end to bring prices in line with international prices and promote the use of natural gas over coal and fuel oil in order to reduce air pollution. Once this occurs, prospects for the Group's energy segment should improve materially.

Sarine announced a profit warning for the third quarter of 2015. There are ongoing disruptions in the diamond supply chain. First, the Antwerp Diamond Bank closed in October 2014, reducing the credit available to traders. Some had to liquidate inventory, creating a glut of polished diamonds. Second, the Gemological Institute of America laboratories released 0.3-0.5 carat diamonds into the market, which exacerbated the glut. Third, major diamond producer De Beers has refused to lower prices of rough diamonds far enough for diamond polishers to earn a satisfactory margin, resulting in large-scale rejections of De Beers' rough diamonds by buyers.

The combination of fewer rough diamonds being bought and an oversupply of polished diamonds has sharply reduced demand for cutting and polishing services, such as those provided by the Group's equipment. The polished diamond inventory should normalize after the upcoming peak season, which lasts from Christmas through Valentine's Day. As for De Beers, its owner Anglo American plc is seeing greatly reduced earnings due to lower commodity prices. It is selling assets and reducing capital expenditure. Eventually, it will have to cut diamond prices again. Its refusal to lower prices further has already cost it hundreds of millions of dollars in lost sales.

Once these two issues are resolved, the flow of rough diamonds should resume, and demand for cutting and polishing services should recover.

4. Roads to Riches

Note: The original article failed to consider concession amortization. Over time, amortization charges lead to an accumulation of cash in the expressway companies. Upon concession expiry, they can either return the cash to shareholders via liquidation, or purchase new concessions to generate fresh cash flow. The article has been edited to take amortization into account.

Many investors like the idea of toll roads, provided they are the ones who are *collecting* the tolls rather than the ones who are *paying* the tolls.

As toll roads are reliant on government-granted monopolies, regulation is a key operational risk. Toll increases may not be granted, or concession periods may be shortened. Competing roads may be built nearby, or existing ones may be de-tolled.

For the investor, there is an additional risk – *pricing* risk. The price paid for the investment should reflect the investor's required rate of return. One aspect that is non-negotiable is the return *of* capital: no investor wants to make a loss. Normally, a toll road concession has a limited life, with no value on expiry. Therefore, toll road companies amortize their concessions to reflect the declining value. This depresses the reported profits. The free cash flow generated by a toll road can be approximated by adding back the amortization charges to the reported net profits.

There are some pure-play toll road companies listed in Hong Kong, plus one in Singapore. Of these, 5 have both detailed concession information and easily understood financial statements. Their remaining concession periods range from 13 to 15 years, which implies that the minimum free cash flow yield would have to be 7-8% for the investor to recover his capital. Only the incremental yield above this threshold would be an investment return.

Company	Remaining Concession (wtd. average)	Req. Yield	FCF Yield	Spread	Div. Yield
Anhui Expressway	12.6 years	7.9%	12.0%	4.1%	4.1%
China Merchants Holdings Pacific	12.8 years	7.8%	13.1%	5.3%	7.5%
Shenzhen Expressway	12.9 years	7.8%	12.8%	5.1%	3.8%
Sichuan Expressway	15.4 years	6.5%	17.8%	11.3%	3.8%
Yuexiu Transport	15.1 years	6.6%	11.4%	4.8%	5.6%

The table shows that investors in the stock market are valuing the companies on the basis of free cash flow yield. With the exception of Sichuan Expressway, the other four companies trade in a narrow range of 11.4-13.1% in terms of free cash flow yield, implying a spread of 4.1-5.3% over the minimum yield required for a return of capital, or a simple average of 4.8%.

Essentially, at current prices, shareholders of the four expressways in question can expect to earn 4.8% annually over the next 13-15 years. While this is a meaningful premium to Chinese government bonds, on an absolute basis this seems low given the long time horizon and regulatory risks. Perhaps investors believe that the government will favour these companies with regulatory changes. After all, the government recently proposed allowing toll road concessions to run beyond 30 years.

But in all likelihood, the law was changed primarily to help the *unlisted* toll roads owned by local governments, where the current concession periods will not suffice to pay off the loans incurred during construction. The Ministry of Transport states that in 2014, total toll collection was RMB 392bn, but expenditures, comprising loan repayments, maintenance, taxes and overheads, added up to RMB 549bn, for a shortfall of RMB 157bn.

Another possibility is that tolls may go up faster than inflation. Apart from extending the concession period, this is the only other way to increase collections. But again, the main beneficiaries will be the private toll roads operated by local governments.

With regards to the listed expressway companies, there is no reason for the Chinese government to simply give away the rate hikes or concession extensions when there are minority investors who can be milked for cash via a rights issue.

That leaves us with Sichuan Expressway. Its large positive spread certainly warrants further investigation, but this will be left as an exercise for the interested reader.

Should one then conclude that as a group, expressway stocks in Hong Kong and Singapore are currently trading at unattractive valuations? Certainly, someone who has a deep understanding of how the Ministry of Transport thinks may decide that there will be favourable changes in the future, and that the stocks are therefore attractively priced. But for conservative, long-term investors – who are the archetypal owners of infrastructure assets – the sensible thing to do right now is to stay away.

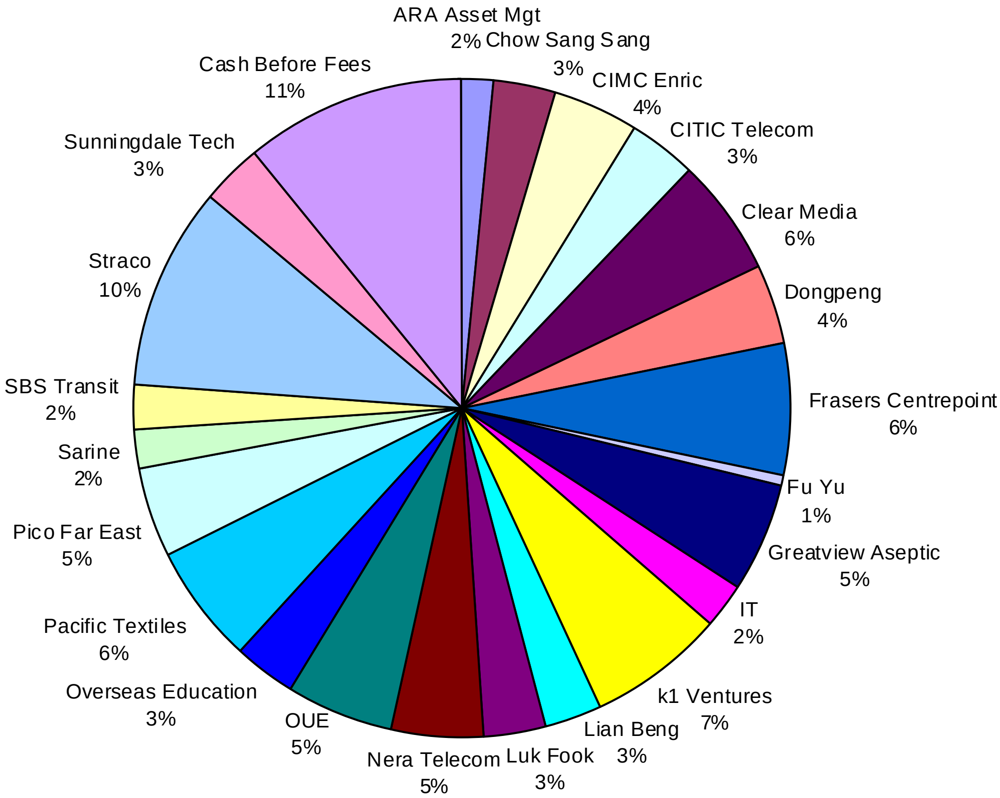
☙ End ❧

LIGHTHOUSE ADVISORS

Keeping Your Capital Safe

Annex I

Fund Holdings as of 30 Sep 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	103.80	103.69	100.99	96.17	85.91	84.17				**-15.8%**

Updated 2 December 2015