LIGHTHOUSE ADVISORS
Keeping Your Capital Safe

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Client Newsletter for the period ended 31 December 2015

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1. Foreword

Fellow Investors,

Welcome to the Lighthouse Advisors newsletter for December 2015.

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

2. Market Commentary

The global economy ended 2015 in relatively poor shape, with the US recovery starting to slow, the European recovery still nowhere to be found, China's economy slowing down and commodity producers in dire straits.

The S&P 500 was down 0.73% while the Dow Jones Industrial Average was off 2.23%, reflecting the slower recovery in the US.

Some other stock markets on the other hand had returns that bore little resemblance to the fortunes of their countries. Despite the UK doing much better than the rest of Europe, the FTSE 100 was off 4.9%.

In Japan, "Abenomics" has yet to show concrete results, but optimists sent the Nikkei 225 index up 9.1%, while in China, the slowing economy was not enough to prevent the Shanghai Composite from ending the year up 9.4%.

Given the Chinese authorities' continued interference in their domestic stock markets, your manager has no real enthusiasm about joining the A-share party any time soon. It is difficult to win a game when your opponent keeps changing the rules.

Hong Kong remains a much more sensible market to get exposure to the Chinese economy, and there are still many attractive opportunities there, especially when the market fell 7.2% in 2015.

India's Nifty index closed down 4% as enthusiasm waned over Prime Minister Modi's reforms given the slow pace of changes.

In Southeast Asia, Singapore's *de facto* position as a safe haven did little to assure investors, as the Straits Times Index was sold down 14% on concerns over bad loans in real estate and the oil and gas sector.

At the time of writing, investor sentiment is souring in Japan, India and China, as the promises of "Abenomics", "Modinomics" and "One Belt One Road" have yet to materialize.

The table below shows a brief snapshot of how some markets performed in 2015 and for the two months ending 29 February. It is noteworthy that the Hong Kong and Singapore markets ended February over 20% below the points at which they began 2015.

Market	Index	2015	YTD 29 Feb
China	Shanghai Composite	+9.4%	-24.1%
Hong Kong	Hang Seng	-7.2%	-12.8%
Japan	Nikkei 225	+9.1%	-15.8%
India	Nifty	-4.1%	-12.1%
Singapore	Straits Times	-14.3%	-7.5%

Over-pessimism presents opportunities for the intelligent investor. The lower prices are, the

higher future returns are likely to be. We are now seeing strong companies selling at reasonable prices, which bodes well for investors. Your manager expects that at least a few such investments will make their way into the Fund this year. The next newsletter will be published for the quarter ended 31 March 2016.

Benjamin Koh
Chief Investment Officer
Lighthouse Advisors
14 March 2016

3. Portfolio Review

As at 31 December 2015, the Net Asset Value (NAV) of the Fund was USD 86.35. Net of all fees, the return for 2015 was -13.6%.

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.

It is now reporting season, and while many companies, especially in China, continue to show slowing sales and declining profits, there remain others which have reported increased profits and declared larger dividends. It is a matter of doing the homework.

New Investments

SmarTone Telecom provides mobile telecommunications services in Hong Kong. It is the smallest major operator by subscriber numbers, but has the highest average revenue per user (ARPU), and thus the best margins among the major operators.

Previously, there were 4 major mobile providers in Hong Kong, with an ongoing price war which dented industry-wide profits. However, CSL, the most aggressive player, was acquired by Hong Kong Telecom in May 2014. There were two consequences. First, having taken on debt to buy CSL, Hong Kong Telecom would prefer to recoup its cost as soon as possible. Second, the deal made Hong Kong Telecom the largest operator by subscriber numbers, giving it the most to lose in a price war. The logical outcome would be a cessation of the price war and a return to rational competition. This is exactly what has happened. Industry-wide, pricing has increased across the board, and unlimited high-speed data plans have been discontinued.

As a mobile-only provider, Smartone enjoys maximum benefit from subscription repricing. Given the business' operating leverage, margins should expand over time as price adjustments outpace cost inflation.

The shares were acquired at 13 times trailing earnings and 3.8 times EV / EBITDA. The yield was 5%.

Divestments

Chow Sang Sang was sold due to deterioration in the business. It is now clear that Occupy Central marked the peak for Hong Kong retail. For the next few years, old lease agreements will escalate rents, even as sales decline in the wake of falling visitor spending. Chinese tourists in Hong Kong have endured much hostility over the past decade, and the recent unrest in Hong Kong has driven the Chinese to spend their money elsewhere, notably Japan.

The shares were acquired for the managed accounts in 2012 at a reasonable price, but had appreciated significantly by the time they were transferred into the Fund as in-specie subscriptions in 2013. After including dividends received, the Fund booked a loss of over 30% on exit.

Luk Fook was sold for the same reasons as Chow Sang Sang: poor operating results with little prospect of recovery for the next few years.

The shares were bought for the managed accounts in 2009 at a very low price, but had also appreciated significantly by the time they were transferred into the Fund as in-specie subscriptions in 2013. Including dividends

received, the Fund booked a loss of over 30% on divestment.

OUE was sold when it became clear that the investment thesis was wrong. Originally, it was expected that the company would divest itself of its property assets over time and return the proceeds to shareholders, eventually becoming a fund management company. This would eliminate the discount placed on the company's real estate holdings, since they would be sold at market prices and the cash paid out. Shareholders would have received a large amount of cash and be left with a valuable fund management business at an effective cost base of less than zero.

However, it is now clear that the company has no intention of returning the sales proceeds. Instead, most of the cash is being kept and recycled. The cash has been used to invest into an investment fund as well as to buy shares of another listed real estate developer. Your manager did not feel comfortable and sold.

After including dividends received, the loss on divestment was about 20%.

SBS Transit was sold after it was determined that the likely rate of return would be unsatisfactory. At the annual general meeting in 2015, an executive director indicated that a lump-sum payment from selling the bus assets to the government was unlikely, which meant deferred payment would be the most plausible alternative.

Your manager also realized that a special dividend of the sales proceeds would draw unwelcome attention given public unhappiness over service standards, which meant the likely eventual outcome of the asset sale was privatization by the parent company at a small premium. Given the lower internal rate of return on the assessed outcome, your manager decided to exit. After including dividends, there was a modest loss of about 5% on divestment.

Mistakes Made and Lessons Learnt

Chow Sang Sang and **Luk Fook** were well-bought, but poorly sold. At the time of purchase they represented good investment value, with good business prospects backed by attractive pricing. However, as the business environment deteriorated your manager was slow to act. As a result, large capital gains achieved early on were not fully captured and were partially given up by the time they were sold. Like **Bonjour** and **Sa Sa**, two other former Fund holdings, they should have been sold once the Chinese government began to slow the flow of Chinese tourists into Hong Kong in 2014. The effect on Hong Kong retail sales would have been easily anticipated, even if the exact impact was hard to quantify. This was already a lesson from 2014, but your manager did not learn it well enough to avoid repeating it: **when in doubt, sell early.**

OUE was a mistake because it was sold too late. Once the restructuring thesis was disproved, by the deployment of cash into the investment fund instead of a special dividend, the correct thing to do would have been to sell at once instead of taking a wait-and-see approach. Lesson learnt: **sell once the original investment thesis is disproved.**

SBS Transit was a mistake in that your manager did not factor in the political sensitivity surrounding the public transport sector, which would make a special dividend unlikely. Lesson learnt: **consider politics when investing in sensitive industries.**

4. Corporate Cash

"Cash is king" is a familiar adage, and often repeated in times of crisis. Cash represents untapped spending power, and when liquidity is tight, it can be deployed for outsize effect.

For the investor in common stocks, cash on the corporate balance sheet is a source of comfort and **protection** against financial distress, but it is not a source of **return**. Idle cash by itself does not represent additional

value *until* it has been put to use. This use can be a cash distribution to the shareholder, or the acquisition of productive assets that can fund future, larger payouts.

In the hands of skilled investors like Warren Buffett, cash is extremely useful. Buffett has been able to invest the cash generated at Berkshire Hathaway at such high rates of return that he has been able to essentially defer dividend payouts indefinitely. Since Buffett took over, a dollar of earnings retained in Berkshire Hathaway has consistently created more than one dollar of value for shareholders. But Berkshire Hathaway is perhaps the exception that proves the rule: Benjamin Graham noted in *Security Analysis* that for corporations as a group, "stockholders in general would certainly fare better in dollars and cents if they drew out practically all of these earnings in dividends".

The saying that "a bird in hand is worth two in the bush" has a direct corollary in the stock market. Within a group of peer companies, the ones that pay out a larger proportion of earnings are generally afforded a better valuation than those which pay out a smaller proportion of earnings, even though the companies that retain more cash would in theory be financially stronger. Less is more: <u>reducing net asset value increases market value</u>.

So how does one value the retained cash on the balance sheet? Clearly, cash has a nominal value, and indeed, in liquidation, all other assets are evaluated on an "as-converted-to-cash" basis. But what about a going concern? The commonly used price/earnings ratio does not take into account the balance sheet of the enterprise in question.

One metric that is in use among some investors is "price/earnings less cash". This subtracts the stated cash on the balance sheet from the company's market value when computing the price/earnings ratio. The logic is tempting: all things being equal, a company that holds more cash is worth more than a company that holds less cash. Therefore, for comparative purposes, one could use "P/E less cash" to value a group of companies.

But this is a simplistic view that does not take into account the fact that all cash is not alike. Cash may be trapped in subsidiaries that are subject to withholding tax, as discussed in the March 2013 newsletter. Or, subsidiaries that are less than 100% owned are still shown on the consolidated balance sheet on a 100% basis, overstating the true level of cash available to the Group. The cash may not even be there most of the time!

Investors who invest on the basis of a margin of safety provided by large reported cash balances should first of all ascertain whether the cash is indeed available.

Ecogreen Fine Chemicals was discussed in the March 2014 newsletter as a case of "negative carry", whereby it was in a net cash position, yet paid more on its debt than it earned on its cash balances. The company's current market value is about HKD 900m, and as of 30 June 2015 it had net cash of HKD 460m, implying that the company's business is selling for HKD 440m.

For the twelve months ended 30 June 2015, the company earned HKD 128m, so on a "price/earnings less cash" basis, the company sells for less than 4 times earnings, an apparent bargain. Yet, given that the implied interest rate earned on its average cash balance has ranged from 0.5% to 1.4%, during a time when 12-month bank deposit rates in China were 2-3%, it is possible that the *average* cash balances at Ecogreen during the normal course of business over the year were only one-quarter to one-half the amounts stated on the balance sheets.

If the stated cash is discounted by 50% to reflect this situation, Ecogreen moves to a net debt position of HKD 233m, and its "price/earnings less cash" ratio becomes about 9, much less attractive. More importantly, the possibility that the cash balance does not reflect the business during normal operations raises additional questions about whether there

are other distortions in the financial statements.

Singapore-listed **Hong Leong Asia** (HLA) is an example where the subsidiaries' cash is *not* available to the parent company. HLA was discussed in the September 2012 newsletter in the context of its special share not actually giving it control of **China Yuchai International** (CYI). HLA's accounts still consolidate CYI, on the basis of control via its special share.

HLA owns just 37% of CYI, which means that even though it consolidates 100% of China Yuchai, only 37% of China Yuchai's net cash of RMB 1.3 bn is available to it. An investor looking at HLA's balance sheet as of 31 Dec 2015 might think that HLA was in a net cash position, with SGD 1 bn of cash against debt of SGD 984m.

However, a more accurate way for the investor to assess HLA's balance sheet would be to first deduct all of CYI's balance sheet items from HLA's balance sheet to obtain HLA's balance sheet on an ex-CYI basis, then add back the value of a 37% stake in CYI as a financial investment. The reason is that not all of CYI's assets are available to offset HLA's own liabilities; HLA is only entitled to its pro-rata 37% share of CYI's assets.

CYI is listed on the New York Stock Exchange, so a market quotation is easily available. Another partially-owned subsidiary, 74%-owned Tasek, is listed in Malaysia, but Tasek's minority interest is smaller both in percentage and absolute terms, so the adjustment here is less important. When CYI is treated as an investment, HLA moves to a net debt position. Tasek is also in a net cash position, so adjusting for Tasek's minority interest worsens the picture for HLA further.

Another example of where cash exists, but is not easily available, is NASDAQ-listed **Apple**. The maker of the iconic iPhone reported cash holdings of USD 203 bn for 30 June 2015. Yet in February 2016, Apple issued USD 12 bn of bonds to raise cash for dividends and stock buybacks. The reason is simple: over USD 180 bn of Apple's cash sits in overseas subsidiaries, primarily in Ireland. If the cash is brought back to Apple's corporate headquarters in the US for distribution to Apple's own shareholders, it becomes subject to corporate tax of up to 35%.

For as long as that cash is offshore, the tax is deferred, and the cash can be used at its full value to make investments and acquisitions. Indeed, video game publisher **Activision** did just that in November 2015, when it used USD 3.6 bn of offshore cash to help fund its purchase of mobile game maker **King Digital Entertainment**.

Apple has chosen to borrow money instead of paying the taxes, essentially betting that it will be able to earn more on the offshore money than it pays in interest on the onshore debt. In the meantime, bondholders are happy to let Apple borrow cheaply, knowing that in the worst-case situation, Apple can simply wire money from Ireland, pay taxes, and repay the bonds. So the cash *is* available to Apple shareholders (and bondholders), but only with a punitive 35% haircut.

Even if the cash on the balance sheet is deemed to be available, the management may well refuse to pay it out, citing plans to deploy that cash soon into new investments, or the need to keep a reserve for emergencies.

Since 2013, shareholder activist David Webb has waged an online campaign against Hong Kong-listed **Yorkey Optical**. Interested readers can peruse Mr Webb's articles for themselves, but essentially, in 2006 Yorkey raised a large sum of money prior to and during its IPO, and then simply sat on it.

In 2013 Mr Webb tried but failed to get minority shareholders to veto Yorkey's connected transactions with its largest shareholder Asia Optical, to spur the management to return the cash. Mr Webb tried again in 2015, and this time the minority shareholders vetoed the connected transactions.

Unfortunately, to date Yorkey has yet to pay out a meaningful portion of the cash. As of 30 June 2015 the company held USD 125m of cash, of which Mr Webb estimates at least USD 100m is clearly surplus to operational requirements.

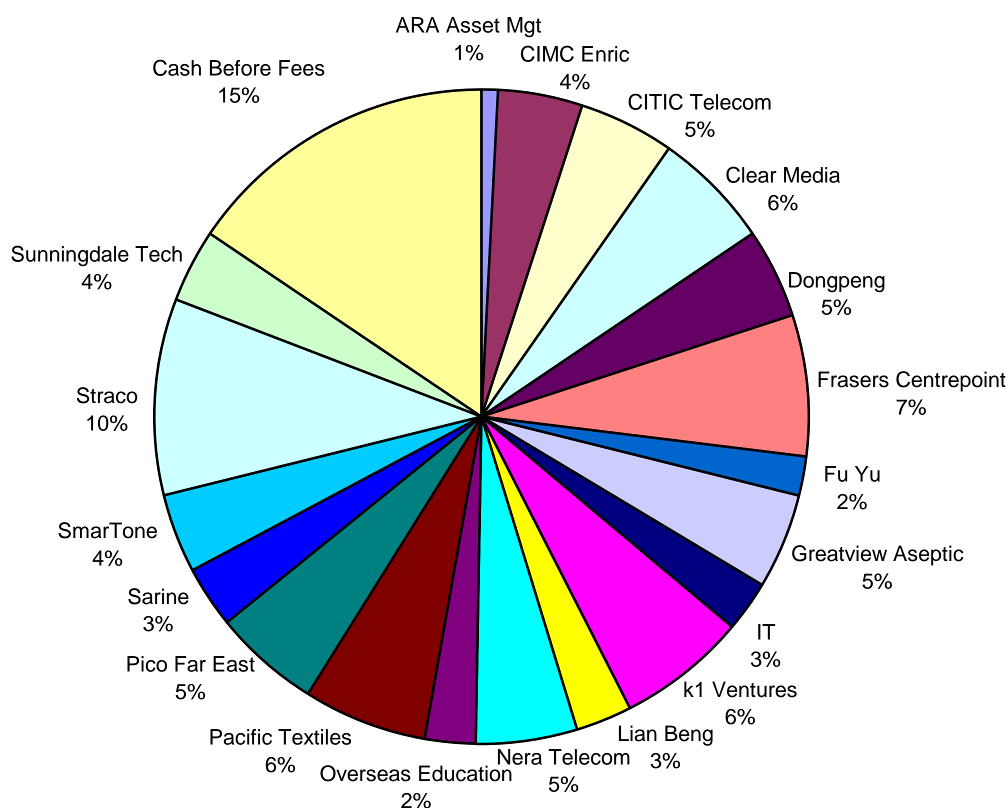
Some time after the minority shareholders' veto, the company issued a profit warning that its annual results for 2015 would show a decline on account of decreased operating revenues and loss of an associate. Presumably, some of the decline was due to the loss of sales to Asia Optical. The management seems inclined to hang on to the cash, so it may be a long fight ahead for minority shareholders of Yorkey.

These four examples should make clear that the only time a cash hoard can reasonably be valued at par is when (i) it is clear the cash actually exists, (ii) there are no minority claims on the cash, (iii) the cash can be repatriated to the holding company at minimal cost, and (iv) the cash is indeed being paid out.

☙ End ❧

Annex I

Fund Holdings as of 31 Dec 2015



Annex II

	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	YTD
2008										34.16	33.49	35.62	**+4.3%**
2009	34.57	33.52	33.37	36.69	46.20	46.00	50.06	49.68	52.66	54.17	56.68	59.94	**+68.3%**
2010	59.05	61.09	65.17	68.27	64.14	65.69	70.65	72.24	81.06	83.56	85.10	90.30	**+50.6%**
2011	87.21	86.29	88.13	92.81	90.85	91.35	91.17	83.69	69.04	78.23	73.00	72.88	**-19.3%**
2012	77.40	82.90	82.52	83.32	76.36	77.25	77.27	77.91	80.57	79.44	82.70	84.92	**+16.5%**
2013	91.43	97.36	99.96	100.24	99.14	95.09	98.50	100.00	100.86	102.24	102.63	102.93	**+12.6%**
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	88.91	86.20	86.35	**-13.6%**

Note: The Net Asset Value of the Fund has been linked to the rebased NAV of the Reference Account, which had the same investment style. Until the launch of the Fund, the Reference Account served as the model portfolio for all the separately-managed client accounts. Its trading records were distributed to clients as proof that the Manager's interests were fully aligned with those of the clients. The Reference Account was started at the end of 2008 and became inactive following the launch of the Fund on 1 September 2013.