LIGHTHOUSE ADVISORS
Keeping Your Capital Safe

Lighthouse Advisors Private Limited
Reg. No. 201212773E
Suite 1103, #11-00 The Octagon
105 Cecil Street, Singapore 069534
www.lighthouse-advisors.com

Client Newsletter for the period ended 31 March 2017

1. **Foreword**
2. **Market Commentary**
3. **Portfolio Review**
4. **Payables**

1. Foreword

Fellow Investors,

Welcome to the Lighthouse Advisors newsletter for March 2017.

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

2. Market Commentary

US president Donald Trump promised it would not be politics as usual. Unfortunately, such bravado has merely exposed his naïveté, as he has run headlong into the reality that politics is not business. In business, the CEO is effectively God within the company; his word is law. In politics, the president is bound by due process, with the result that Trump's travel bans and healthcare repeal have failed.

Trump's campaign declarations targeting Muslims have returned to haunt him as evidence that his travel bans are disguised anti-Muslim measures, while many of his party members abandoned "Trumpcare" when it became clear that millions of voters would lose insurance coverage[1], and would then kick the Republicans out at the next elections.

The proposed border tax measures have also created chaos. Two decades after the North American Free Trade Agreement was signed, many companies have supply chains that repeatedly cross the US-Canada and US-Mexico border. Once Trump is presented with hard evidence that the border tax will meaningfully raise prices to consumers, it would be political suicide to press ahead.

Very few finished goods are manufactured from scratch in the US – or indeed anywhere in the world. Trump previously boasted of engaging Apple to manufacture in the US. Great, except that Apple uses over 200 suppliers, most of whom are not in the US. A border tax of any sort would increase the price of Apple's products, and the blame would fall squarely on Trump.

Trump's latest admission that being President is "more work than in [his] previous life"[2] is the closest he has come to conceding he is out of his depth. It takes quite an ego to believe leading the world's most powerful country could be easier than running a business conglomerate, however large it might be.

Longer-term, the US will survive Donald Trump, but the short-term impacts will be felt for some time. Already, applications to American universities by students from the Middle East have fallen materially[3]. As these students are likely to form the next generation of immigrants, their decision to study elsewhere is America's loss. 40% of the US Fortune 500 companies, including AT&T, IBM, Coca-Cola, Microsoft, McDonald's, Goldman Sachs, eBay, Kohl's, Comcast, Pfizer and Yahoo, were founded by immigrants or their children[4]. Other "cool" companies like Amazon, Apple, Google and

[1] *American Health Care Act – Budget Reconciliation Recommendations*, **Congressional Budget Office Cost Estimate**, 13 March 2017.

[2] *Exclusive: Trump says he thought being president would be easier than his old life*, **Reuters**, 28 April 2017.

[3] *International Applicants for Fall 2017 – Institutional and Applicant Perceptions*, **Institute of International Education**, 13 March 2017.

[4] *The CEOs revolting against Trump's travel ban*, **The Atlantic**, 20 January 2017.

Tesla were also founded by immigrants or their children. If Trump wants to "make America great again" the logical thing to do would be to accept *more* immigrants, not less.

Europe continues to be mired in uncertainty. The first quarter was marked by continued squabbling in the UK Parliament over Brexit; that has been "resolved" with the triggering of Article 50 on 29 March. Now begins the long process of negotiations, in which the UK begins at a clear disadvantage, with Germany determined to demonstrate to other potential leavers that exiting the EU is a bad idea, and Spain also determined to prevent Scotland from getting an easy re-entry into the EU, lest it inspire its restive Catalonia region.

In China, the economy continues to function normally, but the slower growth has intensified competition everywhere, with many companies closing stores and plants in order to consolidate their operations. Declines in same-store-sales and net shrinkage in store networks are par for the course at present. State-owned enterprise reforms also continue apace, with the latest target being the power sector. China Shenhua, China's largest coal miner, and China Datang, one of China's largest power generation groups, have been prodded to merge to realize cost synergies[5].

Korea has not solved its headaches despite jailing its former president Park Geun-Hye. Economically, it now faces China's wrath over the proposed deployment of the Terminal High Altitude Area Defense (THAAD) system. THAAD is meant to help defend South Korea against a missile attack from North Korea, but China has deemed it a threat to its own security. Chinese travel packages to Korea have been cancelled, and Chinese cruises have swapped their Korean destinations for Japanese ones. Nearly 50% of Korea's foreign tourists in 2016 came from China, so the impact is significant.

Within China, Korean businesses have also been impacted. The Lotte Group, which sold the land for THAAD to the Korean government, has been hard-hit: of its 99 Lotte Mart stores in China, 67 have been suspended by the government, while 20 have voluntarily closed due to anti-Korea protests. Industry watchers estimate the closures will cost Lotte over US$100m a month in lost revenues[6]. This is just one more reminder to investors that they ignore politics at their own peril.

In Hong Kong, Carrie Lam has been chosen to be the next chief executive. Despite a glittering career in the civil service, Beijing's support for her means many now view her as a mere puppet. It will be an uphill battle for her to implement her policies, even if they are well-founded. Hong Kong residential property is famously unaffordable and remains a cause of deep-rooted unhappiness. It remains to be seen if Ms Lam can improve things. For now, the much-reduced number of Chinese tourists has hit retailers hard, and landlords are finally reducing street-level rents.

In the Singapore and Hong Kong stock markets, your manager's prediction of continued buyout activity holds true. The portfolio has already benefited from such actions, and nearly half the portfolio is invested in companies where deals are either active or very likely to occur. For the Fund, given the sheer number of such investments, 2017 will likely be "The Year of The Special Situation".

The Fund has received some subscriptions and welcomes more. Incremental money is currently being put to work at high expected rates of return. The outlook for investments this year is promising. The next newsletter will cover the quarter ended 30 June 2017.

Benjamin Koh
Investment Manager
Lighthouse Advisors
30 April 2017

[5] *China to Push Merger Talks to Form $231 Billion Energy Giant: Sources*, **Bloomberg News**, 29 March 2017.

[6] *Lotte's China biz in peril as THAAD spat deepens*, **Yonhap News Agency**, 20 March 2017.

3. Portfolio Review

As at 31 March 2017, the Net Asset Value (NAV) of the Fund was USD 101.1. Net of all fees, the total return for 2017 was +12.1%.

For reference, for the 3 months ended 31 March 2017, the changes in the Fund's key markets were:

Market	Index	Change
Singapore	STI	+10.2%
Hong Kong	HSI	+9.6%
Shanghai	SSE	+3.8%

23 securities made up 93% 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.

Winners and Losers – Q1 2017 vs. Q4 2016

Sunningdale Tech jumped 50% after it announced its full-year results for 2016. Profit before tax rose 10%, and the dividend was increased by 20%.

Pico Far East rose 32% after it reported that net profit for the year ended 31 Oct 2016 increased 9%. Total dividends for the year were increased by 21%.

800 Super climbed 29% after announcing strong results for the 6 months ended 31 Dec 2016. Net profit increased 65% and the Group declared a maiden interim dividend.

Yingde Gases was up 28% after private equity firm PAG announced an offer to privatize the Group for HKD 6.00 per share.

Fuyao Glass rose 21% after announcing its full year results. Net profits increased 21%. Dividends were maintained.

Fu Yu gained 21% despite reporting that full year net profits to shareholders fell 25%. Dividends were maintained. The stock is in play as some newspaper articles and analyst reports have identified it as a buyout target.

Clear Media was up 20% after announcing its full year results. Net profit increased 6%, and dividends were increased 6%.

Huayu Automotive rose 14% after reporting that 2016 net profits were up 16%.

k1 Ventures dropped 16% after an analyst report suggested that the shares could be overvalued.

Other holdings were not material contributors to changes in the Fund's NAV in Q1.

Quick Trades

Auric Pacific is a food and beverage company. Its key market is Singapore, where its *Sunshine* bread is one of the country's 2 leading brands of bakery products. Other operations include food courts under the *Food Junction* brand and cafes under the *Delifrance* brand. The Group is part of the Indonesian Lippo Group owned by the Riady family. Auric Pacific struggled for many years, but in November 2014 Andy Adhiwana, the son-in-law of Lippo patriach Stephen Riady, joined the company as executive director. Andy improved operations, greatly reducing losses at Food Junction and Delifrance. Debt was paid off, and a cash pile built up.

The Fund began acquiring shares in the Group at about 4 times EV/EBITDA. Shortly after the Fund began buying, Andy Adhiwana and Stephen Riady launched a privatization offer. They crossed the 90% shareholding mark, which allowed them to delist the company. To avoid being stuck with shares in a private company after delisting, the Fund sold its shares, netting a gain of 18%.

New Investments

Frencken is a manufacturer of automotive parts and electro-mechanical products. Its automotive customers include various tier-1 suppliers, who in turn supply to the major automotive brands. Its electro-mechanical products are made for medical companies such as Philips Medical and Agilent. The Group's

founder passed away in late 2014, leaving it without a leader, but in May 2015 an industry veteran from Agilent, Dennis Au, became President, and the Group recovered in 2016.

The late founder's brother is now the non-executive chairman, and has made clear that the Group will be professionally run. To improve returns on invested capital, the Group has sold an underperforming plant in Malaysia to its key customer, Valeo. The proceeds will move the Group to a net cash position and allow for higher dividends in future.

The shares were bought at about 8 times trailing earnings and 0.7 times book value, at a yield of 3.5%. EV/EBITDA was 4x.

Genting Hong Kong is an operator of cruise ships under the *Star Cruises* and *Crystal Cruises* brands. It also owns a 50% share in **Travellers International** (listed on the Philippine Stock Exchange), which operates the Resorts World Manila casino near the Ninoy Aquino airport in the Philippines, as well as 18% of **Norwegian Cruise Lines** (listed on NASDAQ). The Asian cruise market is growing strongly, and to capitalize on this the Group has created a new ocean-going cruise brand called *Dream Cruises*, and is expanding *Crystal Cruises* aggressively into the river cruises and air cruises markets.

Genting's new ships and aircraft should arrive in time to capture the strong growth. In the meantime, the Group is reporting losses due to the startup costs of the new ships and aircraft. By 2019 the ships and aircraft should be operating at steady state, and the Group should be nicely profitable. The Group has also recently resumed paying dividends, suggesting that the outlook going forward is better than past results imply.

The shares were bought at 0.5 times book value, at a yield of 3%.

Innotek is a manufacturer of stamped and machined metal products. It serves the automotive, office automation and consumer electronics industries. The Group ran into problems starting in 2011 and reported large losses in 2012, 2014 and 2015. Lou Yiliang , the manager of a joint venture, was appointed as CEO of the key subsidiary in November 2015. Since June 2016, the company has reported 3 consecutive quarters of profits. For 2016 it also resumed dividends, which had been omitted in 2015. Mr Lou was recently promoted to group CEO. He is highly committed, and the recovery is likely to continue. Although Mr Lou is not the controlling shareholder, he owns a 5% stake, which is a good alignment of interest with minority shareholders.

The shares were bought at about 6 times trailing earnings and 0.7 times book value, at a yield of 1.5%. EV/EBITDA was about 2x. Debt was minimal, while cash, investment securities and an investment property made up 75% of the company's market capitalization.

Television Broadcasts (TVB) is the dominant free-to-air broadcast television operator in Hong Kong with market share of over 80%. It also produces television dramas, variety shows and movies. It also owns nearly 30% of Shaw Brothers Holdings, a movie production company, and 5.1% of Flagship Entertainment Group, another movie production house.

TVB's largest shareholder is Young Lion Holdings. It is controlled by Charles Chan Kwok Keung and counts HTC founder Cher Wang Hsiueh-hong and private equity firm Providence Equity Partners among its shareholders.

In January this year, TVB announced a share buyback exercise to cancel 32% of its shares and thus increase Young Lion's stake. This was later amended to 27%, but the proposed price was raised to maintain the total projected consideration. The shares traded at a meaningful discount to the proposed price, so the Fund bought in.

The shares were bought at 33 times earnings and 2 times book value, with a yield of 2%. The earnings valuation was high due to startup losses in the internet television business.

Yingde Gases is China's largest domestic manufacturer of industrial gases. It operates air separation units at customer facilities in China. Its main products are liquefied oxygen and liquefied nitrogen. Ancillary products include argon.

Starting in the second half of 2014, many customers began having difficulty paying on time. Yingde's founders disagreed on how to handle the situation, and this eventually escalated into a public fight in late 2016. Air Products, an American industrial gases company, expressed interest in acquiring the Group outright. The shares traded below Air Products' proposed price, presenting the Fund with an opportunity to earn arbitrage profits.

Subsequently, all 3 founders agreed to sell their stakes to PAG, a private equity firm. The shares have appreciated accordingly.

The shares were bought at about 22 times trailing earnings and 1.5 times book value, at a yield of 4%. EV/EBITDA was 6.5x.

Divestments

CITIC Telecom was sold due to the likely expiry of its deal to acquire 39% of CITIC Networks. The deal would have made CITIC Telecom a meaningful player in China's internet traffic business alongside China Telecom and China Unicom. Without it, the upside was much lower and your manager opted to deploy the capital elsewhere. Including dividends, the overall loss on divestment was about 10%.

COSCO International was sold due to a realization that the Chinese government had already shifted its restructuring efforts to other sectors outside of shipping, meaning that the Group was likely to remain an orphan stock. Your manager decided to sell and deploy the proceeds elsewhere. Including dividends, loss on divestment was about 5%.

Nera Telecom was sold due to a deterioration in the business. The old CEO retired and his replacement had a different style, resulting in staff attrition. This affected morale and work performance. After dividends, the overall loss on divestment was about 20%.

Smartone Telecom was sold due to a deterioration in the business. Despite an improved competitive landscape from a reduction in the number of operators, the lackluster economy and lack of innovative new handsets made it difficult to raise postpaid rates, which was previously a reliable way to boost revenues. After dividends, the loss on divestment was about 6%.

Other Significant Events

ARA Asset Management held an extraordinary general meeting where a majority of shareholders voted to approve the privatization offer from Warburg Pincus and AVIC Trust.

Goodbaby reported that sales fell 10% in 2016. Operating profits fell 33%, but adjusted for one-off items, operating profits were flat. Dividends were maintained at the same level. The company is continuing its transformation from an original equipment manufacturer into a vertically integrated brand owner. Until the process is complete, gains in the own-brand operations will be offset by losses in the original equipment manufacturing business.

Greatview Aseptic reported full-year results for 2016. Sales fell 2% but net profits rose 6% due to improved margins. The final dividend was increased by 9%.

Huayu Automotive sales for 2016 were up 18% while net profits rose 16%. The final dividend was increased by 23%.

k1 Ventures held an extraordinary general meeting where shareholders voted to approve the sale of its remaining investments in KUE 3 LP and Guggenheim Partners. Once the investments are sold, k1 will become a cash company, and it is likely to liquidate and return the cash to shareholders.

QAF reported its full-year results for 2016. Sales fell 11%, but profits adjusted for one-off items increased by 4%. Dividends were maintained at the same rate, except that shareholders were given a choice to receive dividends in scrip instead of cash.

SAIC Motors reported that 2016 sales rose 13%, while profits rose 7%. The final dividend was increased by 21%.

Sarine Technologies reported full-year results for 2016. Revenues rose 50% and net profits soared 401% as demand returned for its Galaxy diamond planning systems. The final dividend was increased by 67%.

Straco reported its results for 2016. Revenues fell 2%, and net profits fell 5%. The dividend was maintained at the same level as before.

Zhengzhou Yutong Bus reported results for 2016. Sales were up 15% while profits rose 14%. However, dividends were cut 33%. The cut in the dividend is inconsistent with the reported results, and the stock has been put under review.

4. Payables

Payables are sums that a company owes to creditors. These creditors may be employees, suppliers, landlords and so on. Every company will have some payables on its balance sheet. The ratio of trade payables to the cost of goods sold, or trade payable days, reflects how long a company is taking to pay its suppliers. This ratio is usually stable, though for companies in seasonal businesses the ratio will change during the year. Payables are usually considered by investors to be a secondary data point and seldom draw as much attention as sales, earnings or debt. However, unusual levels of payables can give useful information. Some examples are discussed below.

Sitoy is a Hong Kong-listed manufacturer of leather handbags. Among its key customers is American luxury brand **Coach**. For the 6 months ended 31 December 2015, sales and profits were slightly lower than the previous corresponding period, by 3% and 5% respectively. However, trade payables fell by 30% against the previous year.

An observant investor would have realized that something was amiss: either suppliers had suddenly gotten much stricter, or customer orders had dropped, causing orders to raw material suppliers to decline, in turn lowering trade payables. Indeed, half a year later, when results for the year ended 30 June 2016 were released, sales fell 30%. No profit warning was given because the reported profits for the full year fell by only 10%, but this was propped up by an accounting gain on a bargain purchase in the second half. Stripping out this accounting gain, the decline in second-half profit was almost 50%.

The same trend of declining payables was even more pronounced in the 30 June 2016 results. Payables fell 60% against the same period a year earlier. Subsequently, on 27 January 2017, Sitoy issued a profit warning that its 6-month profits for 31 December 2016 would “decrease substantially” compared to the previous period, due to “decrease in global demand from high-end and luxury brand customers in the manufacturing business”.

Investors who waited for the official profit warning to sell were too late: two months earlier, on 18 November 2016, Sitoy’s share price lost 17% in a single day. Between 17 November and 26 January, the stock lost over 30% of its value. A conservative investor taking note of the decline in trade payables could have sold out early, way back in February 2016. Waiting for the 30 June 2016 results to confirm that the declining payables foretold a sales decline would still have let the investor exit in September 2016, two months ahead of the price collapse.

So in this case, a decline in trade payables was an unannounced profit warning.

Tianneng Power is a Hong Kong-listed manufacturer of lead-acid batteries. This is a capital-intensive business with fierce price

competition. High levels of debt are *de rigeur* for the industry. Tianneng reported in its 30 June 2015 interim results that its gearing ratio had improved, from 41% on 31 December 2014 to 29% on 30 June 2015. Total bank borrowings fell from RMB 3.6bn to RMB 2.8bn. This was impressive, but an investor might wonder where it got the cash to pay down its debt when pretax profits were only RMB 338m.

The balance sheet shows that while Tianneng's bank borrowings fell by nearly RMB 800m, this was offset by a RMB 1.2bn *increase* in bills payable. Bills receivable increased by RMB 532m, so the net effect was that Tianneng "borrowed" RMB 665m from its suppliers by delaying payments via the use of bills payable.

As with many such actions, once you start, you cannot stop: Tianneng's bills payables have been elevated for the last 4 accounting periods through 31 December 2016. **Debt-averse investors should take into account bills payable when computing debt ratios.**

Investors should also note that trade payables can be offset by advance payments, which are recorded as assets in the balance sheet. The true level of trade payables should be computed by offsetting any advance payments against the reported trade payables.

Anta is a Hong Kong-listed company that manufactures and sells shoes and apparel under the *Anta* and *FILA* brand names. It is China's largest domestic footwear brand by sales. For 31 December 2016, Anta's trade payables were RMB 916m. Against the cost of goods of RMB 6.9bn, this was 49 payable days, close to the 46 days sales outstanding for trade receivables.

However, inside the RMB 1.7bn of "trade and other receivables" was RMB 523m of "advance payments to suppliers". In other words, Anta is financing its suppliers by making payments in advance of delivery. So Anta has to keep additional cash on hand because the "Bank of Anta" needs to lend money to suppliers.

When Anta's trade payables are adjusted by the advance payments, its adjusted payable days are only 21 days. In previous years it was even worse: during 2012-2015 Anta's adjusted payable days ranged from 10-13 days. For 2011, Anta's adjusted payables days were actually *negative* at -11 days.

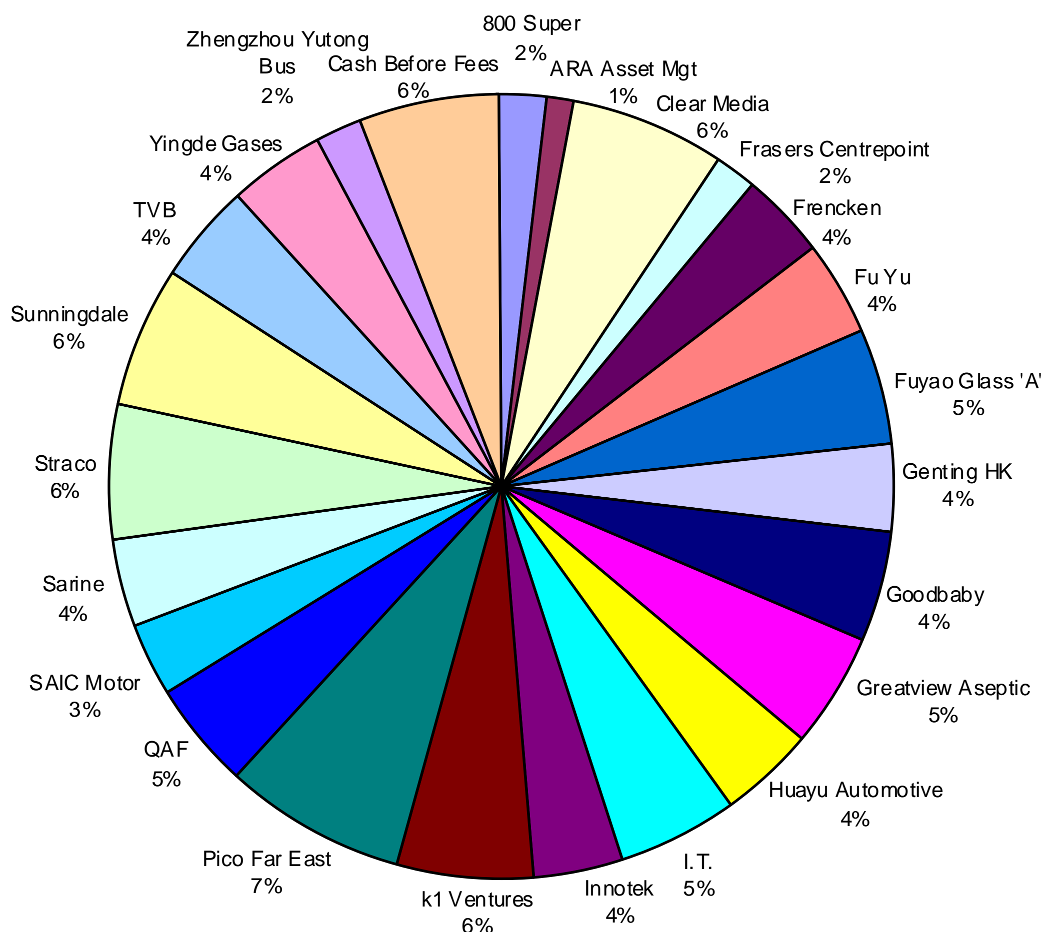
What does this mean? It means that, despite Anta apparently being a strong local brand with great prospects, it is highly dependent on a network of suppliers who are financially weak. **Nike** and **Adidas** make no such payments to their suppliers. True, Nike and Adidas do not manufacture shoes in-house, so they are not strictly comparable. But **Yue Yuen**, the world's largest shoe manufacturer, and a key supplier to Nike and Adidas, reported US$80m of deposits paid to trade suppliers on 31 December 2016, against US$445m of trade and bills payables. Yue Yuen operates in China too, so it would face the same supply chain issues as Anta, but it has kept such advance payments to less than 20% of its trade payables.

Anta is not the only Chinese sports brand financing its suppliers. **361 Degrees**, a competitor listed in Hong Kong, also makes substantial prepayments to suppliers. In 2015 and 2016, such prepayments covered about 30% of the trade payables, while in 2013 and 2014 the prepayments offset about half of the trade payables. In 2011, 361's prepayments offset over 75% of its trade payables.

There is an old saying that "a chain is only as strong as its weakest link". **Risk-averse investors should consider a company's dependence on its suppliers.**

End

Annex I



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	**+21.2%**
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%**
2016	81.56	83.81	88.82	92.18	91.50	91.52	94.48	94.86	94.87	93.34	91.92	90.20	**+4.5%**
2017	93.18	97.08	101.10										**+12.1%**

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.