

Client Newsletter for the period ended
30 June 2018

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1. Foreword

Fellow Investors,

Welcome to the Lighthouse Advisors newsletter for June 2018.

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

2. Market Commentary

The “on-off” trade war seems to be currently “on”. Initially seen as a US-China dispute, it is ensnaring other nations as US president Donald Trump turns on friends and foes alike. Confusion reigns as the key actor, Trump himself, seems to lack any strategy around which the others can negotiate. Rivals and allies have all become “frenemies” in the present chaos.

Trump’s flip-flopping has revived Chinese telecommunications giant ZTE as he ordered that the technology purchasing ban be converted to a fine instead. On the other hand, he has also directed the US Department of Commerce to levy tariffs on another US\$200 billion of imports from China.

Trump also seems to be playing for the Russian team at least part of the time. Despite Special Prosecutor Robert Mueller’s criminal indictment against 12 Russian intelligence officers for interference in the 2016 US

presidential elections¹, the White House has refused to publicly criticize Russia, perhaps because this would be tantamount to admitting that Putin helped to elect Trump.

Canada, a natural US ally given their enormous shared border, has become a target. The Canadians are being hit with tariffs on cars exported to the US. These cars are made in Canadian factories, but by US corporations, for US consumers. Trump’s excuse is Canada’s 270% tariff on certain imported dairy products. The dairy tariff does exist, but quantities within NAFTA-agreed levels are exempt, and in fact no US dairy exports to Canada are above the NAFTA levels, so the 270% tariffs are not actually being paid².

The reality that Trump’s tariffs are bad for America is hitting home as iconic motorcycle maker Harley-Davidson has announced that it will move some production out of the US. The EU’s retaliatory tariffs will raise the cost of US-built motorcycles sold in Europe by about US\$2,200 per motorcycle³. The company has existing plants in Brazil, India, and Australia, and will open a plant in Thailand this year.

Likewise, the largest US nail manufacturer Mid-Continent Nail now faces extinction because steel costs have increased⁴. When it raised prices to cope, sales fell 50% in just 2 weeks. It has already laid off 12% of its workers. What was obvious to businesses is now becoming obvious to their employees.

¹ *United States of America vs. Viktor Borisovich Netyksho et al*, **Robert Mueller, Special Counsel, US Department of Justice**, 13 July 2018.

² *A Trumped-up charge against Canadian dairy tariffs*, **The Brookings Institution**, 13 June 2018.

³ *Harley-Davidson, Blaming E.U. Tariffs, Will Move Some Production Out of U.S.*, **The New York Times**, 25 June 2018.

⁴ *Largest U.S. Nail Manufacturer Could Soon Be Out Of Business Because Of Trump Tariffs*, **The Huffington Post**, 27 June 2018

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Trump's idea of US industrial power is coal and steel. He has yet to let facts get in the way of his actions. But facts do not change regardless of whether they are accepted. And the facts are that in 2017, the respective employment figures for electric power generation were: coal 92,000, solar 350,000, wind 107,000⁵. As for steel, it employed 87,000 people in 2017, while the automotive industry counted 2.5 million jobs, excluding auto dealerships. The numbers are clear: helping coal at the expense of solar and wind, and steel at the expense of cars, is a bad idea.

The economic consulting firm Trade Partnership Worldwide recently released a report analyzing the net effect of the US tariffs on steel and the retaliatory tariffs from trading partners. It estimated that within the first 3 years, **over 26,000 jobs would be created** in the US steel and non-ferrous metal industries, but **over 432,000 jobs would be lost** in the rest of the US economy, creating a net job loss of over 400,000, a ratio of 16 jobs lost for every one created⁶.

In China, it is still business as usual. Domestic demand remains firm, and companies serving local consumption continue to prosper. While exporters to the US will be temporarily affected by the tariffs, in the longer term the companies will adjust, the trade war will come to an end, or some combination of the two will occur. In the meantime, it is time to go shopping in the stock market!

Many Asian equity markets have slipped into a bear market as wary investors move into cash to sit out the storm. Numerous companies, despite not being greatly affected by the trade war, are now trading at attractive levels, with prices marked down as much as one-third despite broadly similar prospects. Any investor with the stomach to invest in

⁵ *U.S. Energy and Employment Report, National Association of State Energy Officials, May 2018.*

⁶ *The Estimated Impacts of Tariffs on Steel and Aluminum, Trade Partnership Worldwide, 5 June 2018.*

strong companies that have been sold down is likely to do well once the trade war ends.

Your manager is reallocating funds within the portfolio towards high-quality companies that have been unfairly sold down. Additional subscriptions are most welcome. The next newsletter will cover the quarter ended 30 September 2018.

Benjamin Koh
Chief Investment Officer
Lighthouse Advisors
16 August 2018

3. Portfolio Review

As at 30 June 2018, the Net Asset Value (NAV) of the Fund was USD 104.37. Net of all fees, the return for the second quarter was -4.3%, and for the first half it was -4.6%.

For reference, below are the changes in the Fund's key markets:

Market	Index	1Q18	2Q18	1H18
Singapore	STI	+0.7%	-4.6%	-3.9%
Hong Kong	HSI	+0.6%	-3.8%	-3.2%
Shanghai	SSE	-4.2%	-10.1%	-13.9%
Fund	n/a	-0.4%	-4.3%	-4.6%

21 securities made up 91% 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 – Q2 2018

Winners	Δ	Losers	Δ
IT	+54%	Sunningdale	-32%
Dawnrays	+13%	EVA Precision	-25%
China Sunline	+12%	Frencken	-24%
Genting HK	+12%	BAIC Motor	-22%

IT soared 54% after reporting strong full-year FY18 results. Sales rose 4.8% but profits rose 37%, driven by strong growth in Japan, the

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most profitable market, but all markets saw improvements, including Hong Kong and Macau, which saw losses reduce significantly. The final dividend was increased by 37%, in line with the growth in profits.

Dawnrays rose 13%. Full-year sales rose 7% and net profits rose 10%. The dividend was increased by 20%.

China Sunshine gained 12%. First-quarter results continued to reflect the effect of price increases as sales rose 49% and profits jumped 161%.

Genting HK was up 12%, however there was no financial news.

Sunningdale plunged 32% as first-quarter results showed a sales decline of 2% and a profit drop of 75%. This was blamed on low utilisation due to fewer orders in the Consumer/IT segment as well as adverse foreign exchange movements which eroded gross margins.

EVA Precision dropped 25% despite reporting that full-year profits increased over 150%. It is possible that trade war sentiment is weighing on the stock, as the company is building a new plant in Mexico which could be affected by Trump's tariffs.

Frencken fell 24% as sales rose 3% but profits fell 59%. However the decline arose because the previous year there was a large gain from selling off its Malaysian assets. Adjusted for the disposal gain, profits actually rose 10%.

BAIC Motor lost 22%. Full-year sales rose 25% but net profits dropped by 65% due to poor results at its Hyundai joint venture, which suffered due to tensions between Beijing and Seoul over the deployment of the THAAD radar system.

Other holdings were not material contributors to changes in the Fund's NAV in Q2.

New Investments

VTech is an electronics company with 3 distinct businesses. Its telecommunications segment produces cordless phones and baby monitors for home use. It is the global leader in cordless phones, however this is a mature cash-cow business that is in decline. To offset this VTech recently bought **snom**, a German company providing high-end VOIP equipment. VTech has taken over the manufacturing of snom equipment and used the cost savings to lower selling prices, which has boosted snom's sales. In a few years, snom's contribution should be meaningful. With snom's higher margins, this segment should also become more profitable.

VTech's electronic learning products business makes educational toys for children. It is the largest company worldwide in this segment and recently bought its main rival **LeapFrog**. As with snom, VTech took over the manufacturing of LeapFrog products. This year LeapFrog will launch many new products and is expected to contribute positively.

VTech's last segment is in contract manufacturing. It serves midsize companies in the professional audio, medical equipment and industrial computing segment.

One factor that may weigh on VTech's earnings this year is the bankruptcy of the world's largest toy retailer **Toys R Us**. Toys R Us was one of VTech's 5 largest customers, so sales this year will be affected. However, the underlying demand is still there, so within 1-2 years other retailers such as **Wal-Mart** and **Amazon** should be able to replace the lost sales from Toys R Us.

The shares were purchased at about 16 times earnings and yielded 7%.

Divestments

800 Super was sold after its latest results showed that contracts had been renewed at lower prices despite the limited competition. Given that other investment opportunities

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were becoming available in the stock markets, your manager decided to sell and use the proceeds elsewhere.

Including dividends, the gain on divestment was about 10%.

Hengdeli was sold after disappointing results throughout 2017. Its luxury watch business failed to perform in line with other watch retailers, who saw their sales recover and issued positive profit alerts. In a meeting in December 2017, the company claimed that after the flat first-half results, second-half results were showing a mid-teens recovery in sales. The subsequent results did not support this assertion. Your manager decided to exit.

Including the special dividend, the loss on divestment was 5%.

Other Developments

Clear Media was suspended on 3 April 2018 due to investigation of cash misappropriations by a cashier. The company has appointed both an independent external law firm and an independent accounting firm to conduct a forensic investigation, and enhanced internal control measures on monitoring cash payments and cash balances. The shares remain suspended and are being carried at the last traded price, less dividends paid.

Genting HK successfully transferred its listing from the Singapore Exchange to the Hong Kong Exchange.

4. Profit Margins

Profits are the basic reason businesses exist. In theory, the higher the profit margin, the better. However, high margins attract competition, which in turn erodes margins. Profit margins vary by industry, but within an industry they are fairly stable, as most competitors can compete on similar terms, preventing excess profits. Likewise, when margins are too low, firms exit and the survivors raise prices, bringing margins back to the long-term

average. In this article, some companies with unusually high margins are discussed.

Silver Base is a distributor of Chinese liquor, or “*baijiu*” (白酒). Its main principal is **Wuliangye Yibin**. Below are Silver Base’s net margins soon after its 2009 IPO:

Yr ended 31 Mar	Net Margin
FY2010	30.0%
FY2011	26.4%
FY2012	23.5%

At first, Silver Base looks attractive. High profit margins and high returns on assets suggest a great business. A look at other publicly-listed liquor producers and distributors shows how incredible (and unbelievable) Silver Base’s margins are:

Company	Net Margin		
	FY10	FY11	FY12
Diageo	16.7%	19.1%	18.0%
Remy Cointreau	10.7%	7.8%	10.8%
Pernod Ricard	13.4%	13.7%	14.0%
Davide Campari	13.4%	12.5%	11.7%
Global Average	13.6%	13.3%	13.6%
Kweichow Moutai	50.2%	55.0%	55.7%
Wuliangye Yibin	31.1%	32.8%	39.4%
Silver Base	30.1%	26.4%	23.5%

The global liquor producer-distributors earn 13-14% net margins on average, while **Kweichow Moutai** and **Wuliangye Yibin** earn 30-50% net. The gap can be explained by the fact that Moutai and Wuliangye dominate among luxury *baijiu* brands and sell almost entirely in China, whereas none of the global brands dominate global luxury liquor sales to the same extent. They thus spend more of their sales on transport, distribution and marketing. Their distributors would also be in a stronger position to play brandowners off against each other and get better margins, one reason why the global players own their distribution arms

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(and show lower overall margins than the production-focused *baijiu* companies).

The higher efficiency of the *baijiu* brands makes Silver Base's margins puzzling. Given their brand strength, there is no need to give distributors like Silver Base a large operating margin. Often, the stronger the brand, the weaker the distribution margins, since well-known products sell themselves without much marketing. For instance, in consumer electronics, **Apple** earns excellent margins, while the reverse is true for its resellers and distributors such as **VSTECS** and **EpiCentre**.

Company	Net Margin			
	2009	2010	2011	2012
Apple	19.2%	21.5%	24.0%	26.7%
VSTECS	1.1%	1.4%	1.4%	1.2%
EpiCentre	2.8%	3.9%	2.9%	0.5%

Were there any warning signs that Silver Base's net margins were not realistic? Yes. These clues were on the balance sheet.

Yr ended 31 Mar	Receivable Days
FY2010	12
FY2011	117
FY2012	189

The jump in receivable days in FY2011 and FY2012 was a red flag for investors. Indeed, the company soon reported rather poor results:

Yr ended 31 Mar	Net Margin	Receivable Days
FY2013	-290.4%	489
FY2014	-161.0%	37
FY2015	-4.6%	66
FY2016	10.3%	21
FY2017	0.4%	24
FY2018	-5.9%	10

The staggering write-downs of FY2013 and FY2014 indicated that the profits of previous

years were illusory, and that recent sales proceeds were largely uncollectible. Silver Base's sales and profit numbers for FY2011 and FY2012 were simply too good to be true.

On a *cumulative* basis, from FY06 through FY18, Silver Base earned HKD 698m on HKD 17.2bn of sales, a net margin of just 4%. This is much more believable given the market dominance of Moutai and Wuliangye. Unfortunately, the last time the company had similar margins was FY06, the earliest year that records are publicly available. That year it earned a 5.6% net margin on sales. In nearly every year since, its margins were either far too high or negative. Without any credible fundamental data, it is simply impossible for a prudent investor to consider the shares of Silver Base at all.

Another case of margins being unusually high comes from payment terminal supplier **Pax Global**. Pax is the 3rd largest payment terminal supplier in the world, behind only **VeriFone** and **Ingenico**. In 2014 Pax shipped about 3m terminals, while competitors **Fujian Newland** and **SZTT Electronics** shipped 2.3m and 1.7m terminals respectively. **Castles Technology**, a Taiwanese player, shipped about 740,000 terminals.

Company	EBITDA Margins				
	2012	2013	2014	2015	2016
Pax	16.5%	17.4%	18.8%	22.7%	23.7%
Newland	6.2%	15.7%	16.7%	14.7%	14.9%
SZTT	12.5%	12.5%	10.0%	11.8%	9.3%
Castles	11.1%	9.6%	7.2%	6.6%	13.5%

Economies of scale do exist, so Castle's poorer margins relative to its peers are explainable. However, what is not so obvious is that despite Pax's larger scale, its margins should be *lower* than its peers.

This is because Pax does not actually do the manufacturing itself. Instead, it designs the firmware and hardware, while the manufacturing is outsourced to PKS, a Japanese-controlled electronics manufacturing

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services provider. Because PKS should logically be earning a profit for its services, Pax's costs should then be higher than those of its competitors, who make their terminals in-house and capture the manufacturing profits.

Since it is PKS and not Pax that is investing into manufacturing facilities, Pax's profits convert into cash at a very high rate. Indeed, according to its financial statements, during 2007-2016, over 95% of its reported profits each year converted into free cash flow.

One might expect a company with such impressive cash flows to pay out generous dividends. Instead, the converse has been true. Prior to its IPO in 2010, Pax was already debt-free and held HKD 244m of cash. The IPO raised another HKD 750m, and Pax went on to accumulate HKD 1.9bn of cash by the end of 2014. It was only in 2015 that it began paying dividends, but these were just HKD 44m, or 9% of that year's profits. This was raised to HKD 89m in 2016 and maintained for 2017.

A logical question is: what is Pax doing with the cash? There are only a few rational things a company can do with excess cash: expand its business, pay down debt, buy back shares, or pay out the cash.

Pax's sales have grown nearly 5-fold from 2010 to 2017, but it has not needed to invest in factories. Pax has no debt to retire. It has not bought back a meaningful proportion of its shares. And dividend payouts have been modest versus its earnings and cash hoard.

From 2010 to 2017, total payouts comprised dividends of HKD 222m and buybacks of HKD 23m, against inflows of HKD 750m from the IPO, HKD 86m from the exercise of stock options, and HKD 2.2bn from operating free cash flow.

In all, Pax has accumulated HKD 3bn of cash in the last 7 years, but paid out only 8% of this amount. This seems unusually conservative for a debt-free company whose business

model regularly produces large amounts of cash. Skeptics might ask if the cash exists.

One hint is interest income. Cash balances as large as those reported by Pax must generate significant interest income. Pax's annual reports show that about half its cash is held in RMB, with most of the rest in HKD or USD, so its effective interest rates should be a blend of RMB and HKD/USD rates.

Consider the official Chinese bank deposit rates: from 2010 through 2014, deposit rates were above 2%, reaching 3.5% in 2012. Only recently have they declined to about 1.5%.

Even if HKD/USD deposits paid nothing, with half its cash in RMB Pax should have earned at least 1% to 1.75% overall on its cash each year, and only recently would it earn less than 1%. In fact, Pax has been significantly under-earning on interest income. For instance, in 2012, when Chinese bank rates peaked at 3.5%, Pax earned just 0.8% on its average amount of bank deposits. It seems odd that a business as efficient and profitable as Pax could be so sloppy about its cash management.

Has Pax been overstating its profits, and thus its cash balances? This would explain both the low interest income and the reluctance to pay out the idle cash, because that cash might not in fact exist at all. While nobody has published any proof of fraud at Pax, growing market suspicions may be why the share price of Pax has plummeted from a peak of HKD 14 in 2015 to below HKD 4 today.

Of course, the company can disprove the fraud accusations by simply paying out a big special dividend, or executing a tender offer for a large percentage of its own shares. The resulting cash outflow would silence the naysayers and benefit shareholders. Why neither action has been taken is a puzzle to which only the controlling shareholder has the answer. Until then, Pax minority shareholders should be prepared to wait in limbo.

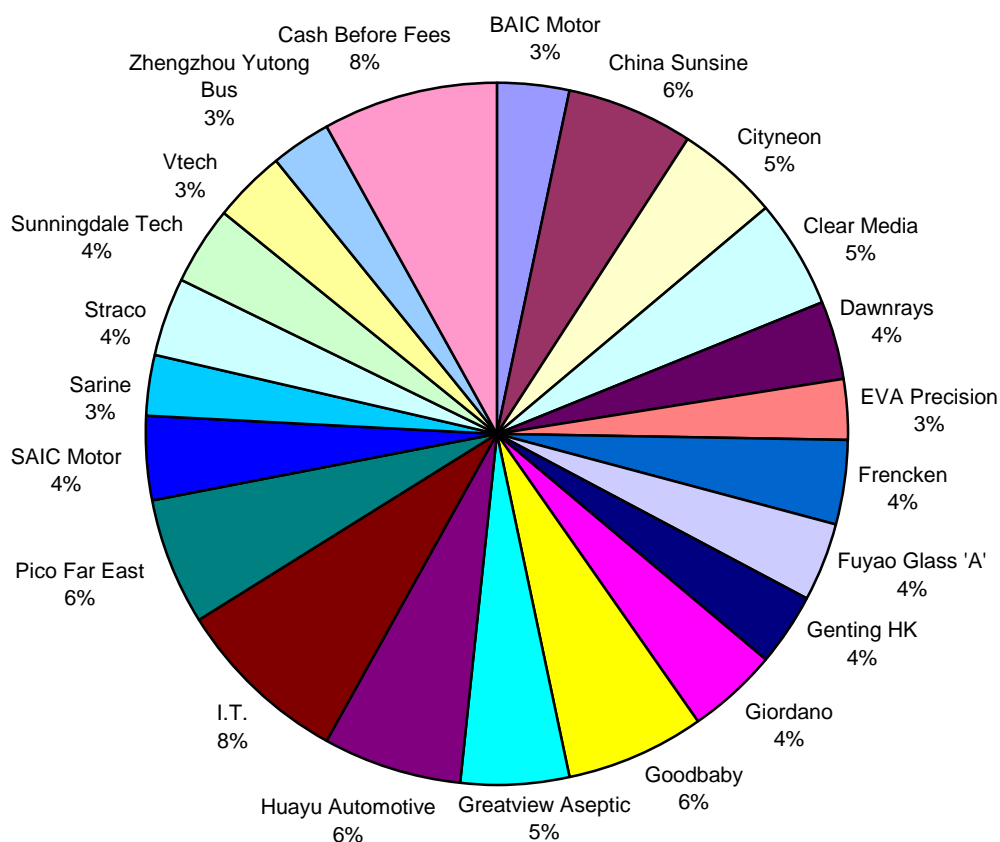
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Annex I

Fund Holdings as of 30 June 2018



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	101.39	105.74	107.11	109.67	108.57	109.35	112.57	108.28	109.41	+21.3%
2018	113.04	109.56	109.03	105.39	109.62	104.37							-4.6%

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.