LIGHTHOUSE ADVISORS
Keeping Your Capital Safe

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Client Newsletter for the period ended 31 Mar 2020

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1. Foreword

Fellow Investors,

Welcome to the Lighthouse Advisors newsletter for March 2020.

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

2. Market Commentary

Covid-19 continues to rule the news headlines worldwide. At end-April, confirmed infections exceeded 2.8 million, and confirmed deaths were nearly 195,000. It is not the common flu – it is *less* infectious, but more lethal.

Most countries have implemented lockdowns of some sort, hoping to copy China's success at controlling the outbreak. However, the resulting economic fallout from "freezing" normal activity is also causing great concern.

The first level of economic damage is obvious: travel and leisure. These have been dubbed the BEACH industries: Booking, Entertainment, Airlines, Cruises, and Hotels[1].

However, the widespread social distancing measures have also impacted local businesses, from restaurants to hairdressers. The informal sector has been hit especially hard, as street hawkers and street walkers alike face sharply reduced demand[2]. Many governments have implemented relief measures, often combining both corporate bailouts and direct payments to taxpayers.

Stock markets plunged in the early months of the year, but rapidly recovered as governments announced aid packages. However, the incoming earnings announcements show that economic recovery is still some way off. Investors should expect poor earnings or even losses this year, even as stock prices assume normalcy returns in 2021.

In the meantime, investors should brace for turbulence. One recent example: reduced economic activity has curbed oil demand, and crude oil prices have fallen. The May WTI futures contract closed at a record low of *minus* US$37.63 on 19 April[3]. Apart from a supply/demand imbalance, at contract expiry, WTI contract holders had to take delivery in Cushing, Oklahoma. Local storage was almost full, so contract holders ended up *paying* buyers to take the oil (and store it).

Your manager took advantage of the market declines to buy into more high-quality businesses. While the overall economic outlook for 2020 is poor, these businesses are gaining market share and pricing power. Your manager expects these companies to materially outperform the broader market over the medium- to long-term.

The next newsletter will be written for the period ending 30 June 2020.

Benjamin Koh
Chief Investment Officer
Lighthouse Advisors
18 May 2020

[1] *The Hardest Hit Companies of the COVID-19 Downturn: The 'BEACH' Stocks*, **Visual Capitalist**, 24 Mar 2020.

[2] *COVID-19 crisis and the informal economy: Immediate responses and policy challenges*, **International Labour Organization**, 7 May 2020.

[3] *Oil price crashes into negative territory for the first time in history amid pandemic*, **Reuters**, 20 Apr 2020.

3. Portfolio Review

As at 31 March 2020, the Net Asset Value (NAV) of the Fund was USD 67.15. Net of all fees, the year-to-date return was -18.9%.

It was a difficult quarter for the Fund, especially after a promising 4Q in 2019.

For reference, below are the results of the Fund against its key markets. As the Fund now has material positions in NASDAQ-listed companies, that market is shown also:

Market (Index)	1Q20
Singapore (STI)	-23.0%
Hong Kong (HSI)	-16.3%
Shanghai (SSE)	-9.8%
USA (NASDAQ)	-14.2%
Fund	**-18.9%**

27 securities made up 89% of the Fund's holdings, with the balance in cash and cash equivalents. A pie chart is in Annex I, while NAV values are tabled in Annex II.

As virtually all of the Fund's holdings declined materially with the marketwide selloff during the Jan-Mar period, a list of winners and losers is not meaningful.

<u>**New Investments**</u>

Alphabet is the parent company of Google, the world's most-visited website and most-frequently used search engine.

Advertising contributes 70% of revenues and all of the Group's profits. The investment thesis can therefore be simplified as a bet on global e-commerce. Outside China, Google is the dominant source of internet traffic for most websites, and this is expected to persist for at least the next 5-10 years. The cloud computing business accounts for only 5-6% of sales, but is growing at high double-digits, and is expected to be the next engine of growth.

The Class A shares were acquired at about 22 times 2019 earnings. There is no dividend.

Booking Holdings is the world's largest online travel agent (OTA). Its key brands include *Booking.com*, *Agoda*, *Priceline*, *Rentalcars.com*, *OpenTable* and *Kayak*. Through these brands, customers can book accommodation, flights, restaurants, cars and other travel related activities.

2020 earnings are expected to be badly affected by the Covid-19 pandemic, and the company has withdrawn earnings guidance for 2020. However, it should recover once travel picks up after the pandemic. This is an investment where the outcome (recovery) is fairly certain, but the time horizon is not.

The price paid was about 13 times 2019 earnings, and trailing yield was 4%.

ESR-REIT is an industrial landlord. It owns 57 properties in Singapore valued at S$3bn. Occupancy exceeds 90%, and there are over 300 tenants, with the top 10 contributing about 30% of income.

As rent is a relatively small part of most industrial business costs, widespread defaults in the portfolio due to Covid-19 disruptions are unlikely. However, 2020 distributions will be back-loaded, as the Singapore government is letting commercial and industrial tenants defer rental payments for up to 6 months.

The units were acquired at 0.7x book value. Yield was 13% based on 2019 distributions.

NetEase is a Chinese publisher of online games for mobile phones and personal computers. Besides its own games such as *Fantasy Westward Journey* and *Westward Journey Online*, it is also the exclusive partner of major foreign studios in China, including Blizzard, Marvel, Microsoft and Warner Brothers. Games published through these partnerships include *World of Warcraft*, *Starcraft II*, *Diablo III*, *Hearthstone*, and *Minecraft*.

The shares were acquired at about 22 times adjusted 2019 earnings. Normalized yield was about 1%.

Oversea-Chinese Banking Corporation (OCBC) is one of Singapore's 3 local banks, the others being DBS and UOB. The 3 local banks dominate the banking landscape and gather most of the deposits, giving them the lowest cost of funds.

The shares have been sold down with the general market despite the company's general conservatism. It is expected that the company's earnings will recover in line with the economy as the pandemic passes.

The shares were bought at about 0.85x book value and 8 times 2019 earnings, with a trailing yield of 5.9%.

United Overseas Bank (UOB) is another of Singapore's 3 local banks, part of the DBS-UOB-OCBC triumvirate.

As with OCBC, UOB shares have sold off with the general market. The company's earnings should recover after the pandemic.

The shares were purchased at 0.8x adjusted book value and 8 times 2019 earnings. Trailing yield was 6.5%.

Divestments

Clear Media was sold after it received a buyout offer from a consortium consisting of JCDecaux, the founding Han brothers, Ant Financial and CWG Fund. After including dividends received during the holding period, the Fund sold its last shares for a gain on divestment of about 50%.

Frencken was sold due to an expected slowdown in the auto sector. Your manager decided to sell while the company was still reporting good news. Including dividends received, the final shares were sold for a gain of about 175%.

Keppel DC REIT was sold because it was assessed that during the market-wide selloff, other stocks had become more attractive. Including dividends, the loss on divestment was less than 5%.

Mapletree Industrial Trust was sold because other stocks had become more attractive during the selloff. Including dividends, the loss on divestment was under 10%.

Other Developments

Nil.

4. Meaningless Lease Payments

Real Estate Investment Trusts (REITs) have become immensely popular among investors in the last 2 decades. There are good reasons for this, the obvious one being the steady cash flow due to the high payout ratios (typically 90%) mandated by their regulators.

Office and industrial properties are well-suited to such requirements, as their leases typically run for years and rental payments are stable from month to month.

Retail properties do experience seasonality, but the REITs moderate this by requiring a fairly high base rent even in the off season, with the result that retailers bear the brunt of the seasonality, often depending on the peak season for the year's profits.

Hotel properties also face seasonality, but because hotels sell their rooms by the night, they do not have long-term tenants, so there is no way to mitigate seasonality. Instead, hotel REITs often have a master lease agreement with a hotel operator, who then undertakes to pass through most of the underlying cash flows to the REIT.

To give some semblance of cash flow stability, the master lessee may commit to a minimum lease payment, so that during periods of low occupancy the REIT will still receive some cash flows. Otherwise, the REIT may also directly manage the hotel itself, or outsource it to a hotel manager without any minimum payment agreement. In such a case, the REIT bears the full brunt of any decline in demand, but of course enjoys the operating leverage during good times.

The issue, however, is that the minimum lease payments may be too low, which makes such arrangements questionable, since the whole point of giving up some upside in good times is to enjoy sufficient protection in bad times.

Below are CDL Hospitality Trust (CDL-HT), Far East Hospitality Trust (FEHT), Frasers Hospitality Trust (FHT), and Eagle Hospitality Trust (EHT). All four are listed in Singapore.

Hotel REIT	2019 Hotel Rent	Min. Rent	Trust Expenses
CDL-HT	S$128m	S$53m	S$65m
FHT	S$148m	S$56m	S$41m
FEHT	S$94m	S$67m	S$43m
EHT	US$92m*	US$61m	US$33m^

**2020 forecast*
^ annualized from 4Q 2019

For CDL-HT and FHT, the minimum lease payments are set conservatively, at 38-41% of the actual rent received in 2019. On the other hand, FEHT and EHT have set the minimum rents at 65-70% of the actual rents (EHT is a new listing, so 2020 forecast rent was used).

Does it matter whether the lessee guarantees 40% or 70% of the rents? Lower guarantees protect lessees, since they will not be out of pocket until the hotels' operating income falls by more. But leasing is a zero-sum game: a lower rent floor means unitholders will <u>not</u> enjoy the stable cash flows that REITs widely advertise as their calling card. In fact, because the REITs still have fixed expenses, notably interest payments on debt, distributions will decline by more than 30% if rents fall by 30%, and the picture is disproportionately worse if rents fall by 60%.

In the case of CDL-HT, versus the actual trust expenses of S$65m, if minimum lease payments were triggered, "rent minus trust expenses" moves from a surplus of S$63m to a *deficit* of S$12m. Unitholder distributions would be wiped out, and the REIT could actually run short of working capital.

FHT has lower trust expenses, so "rent minus trust expenses" still remains positive if minimum rent payments are triggered, but the surplus drops from S$107m to S$15m. Unitholder distributions fall by 86%.

For FEHT, the "rent minus trust expenses" surplus declines from S$51m to S$24m, a loss of "only" 53%. Unitholders could still see their distributions halved.

EHT appears similar to FEHT, with the "rent minus trust expenses" surplus also falling 53%, from US$59m to US$28m. Again, unitholders risk losing half their distributions.

The above analysis shows that minimum lease payments are in fact of little help to unitholders, who risk losing half or more of their distributions in a downturn. For CDL-HT, even working capital could be a problem. **In all 4 cases, the minimum lease payments, in the context of providing <u>stable cash flows to unitholders</u>, are essentially meaningless.**

A second problem arises from the fact that these four REITs have master lessees, which are linked to the sponsors themselves: how strong are these sponsors/lessees? In the event of an extended downturn, the lessees will have to pay out of their own reserves. Consider the respective sizes of the sponsors/lessees:

Hotel REIT	Sponsor / Lessee	Sponsor FY19 Net Assets	REIT Min. Rent
CDL-HT	City Developments	S$11.3bn	S$53m
FHT	Frasers Property	S$16.1bn	S$56m
FEHT	Far East Organization	$14bn*	S$67m
EHT	Urban Commons	Not disclosed	US$61m

**estimated combined net worth of the 2 Ng brothers who control Far East Organization*

City Developments, Frasers Property and Far East Organization are property conglomerates with several decades of operating history. It is clear that in the worst case scenario, where hotel revenues collapse, none of them will have problems paying the minimum rent out of pocket, as they have plenty of other assets that they can tap.

In the case of Urban Commons, the EHT IPO Prospectus states that as of 31 Dec 2018, Urban Commons managed over US$1 bn across 14 properties, of which 12 properties ended up in the EHT portfolio. Urban Commons was described as managing/owning a further 12 properties "under various stages of entitlement and development" meaning that none of these properties was generating cash, rather they were consuming cash since they were not operational.

Therefore, it seems that Urban Commons does not have sufficient additional operating assets that could generate cash flow to help pay the minimum rent. In the event of a downturn, it would have problems.

Indeed, on 24 Apr 2020 EHT announced that Urban Commons had defaulted on 14 of its master lease agreements, with the result that one of EHT's lenders, Wells Fargo, has demanded immediate repayment.

EHT further announced on 15 May 2020 that it had discovered undisclosed interested party transactions: the 2 EHT founders (also 50:50 owners of Urban Commons) had caused EHT's subsidiaries (as Master Lessors) to guarantee the obligations of the Master Lessees (subsidiaries of Urban Commons). This is equivalent to a landlord promising to pay the bills of its tenants, clearly a ridiculous commitment that no genuine lessor would make on behalf of a lessee. It seems likely that fraud has been committed against EHT unitholders.

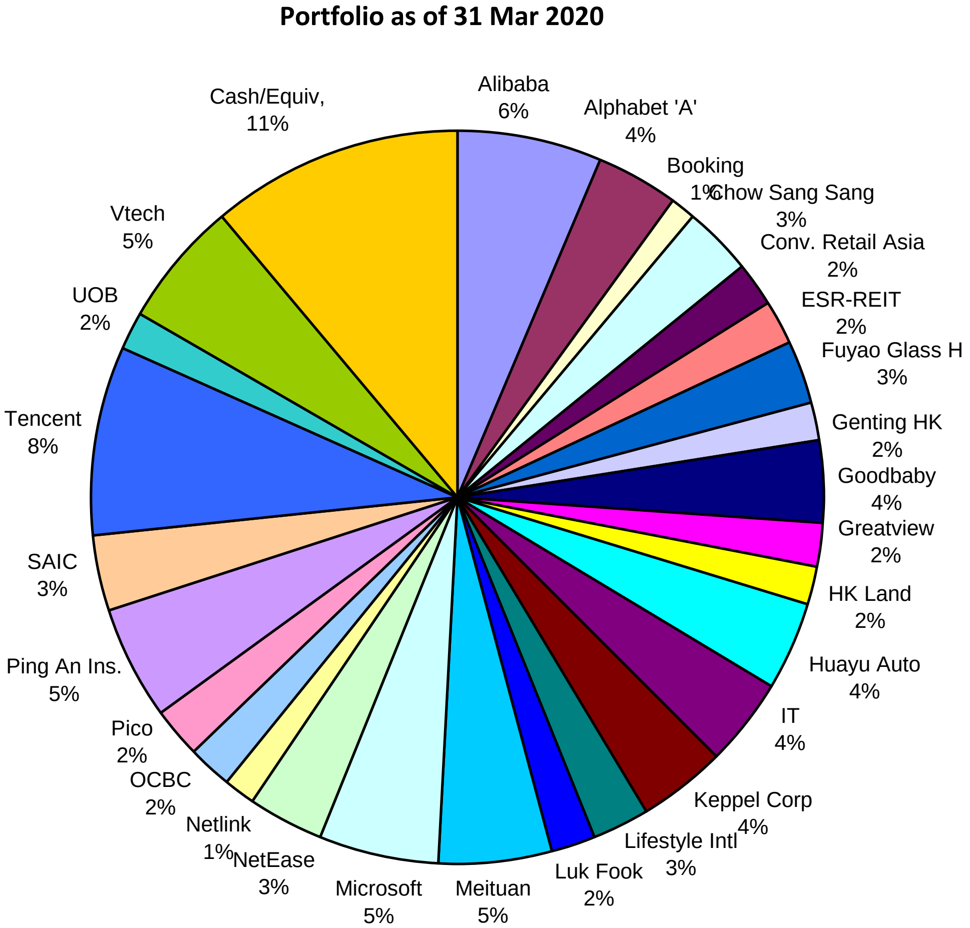
In conclusion, hotel REITs are fundamentally flawed, because:

(i) the minimum lease payments are often set too low to deliver stable cash distributions to unitholders; and

(ii) unless the sponsor is large and well-capitalized, with a long operating history, and possesses significant other assets that can be used to meet the rental commitment, even the minimum lease payments are not safe.

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	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	101.26	93.71	94.25	85.19	86.83	86.66	**-20.8%**
2019	91.98	92.36	90.04	90.21	82.80	84.21	82.57	78.45	76.52	77.82	78.75	82.80	**-4.5%**
2020	78.58	75.37	67.15										**-18.9%**

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.