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Client Newsletter for the period ended 30 Jun 2020

1. **Foreword**
2. **Market Commentary**
3. **Portfolio Review**
4. **Choose Your Parents Wisely**

1. Foreword

Fellow Investors,

Welcome to the Lighthouse Advisors newsletter for June 2020.

This newsletter follows the same format as previous issues. The special topic for this issue is **Choose Your Parents Wisely**.

2. Market Commentary

The Covid-19 pandemic has resulted in a bifurcated world. Many countries appear to be managing the outbreak and are cautiously reopening their economies, with "travel bubbles" between countries judged to have similar levels of infections. However, the BEACH (**B**ooking, **E**ntertainment, **A**irlines, **C**ruises, **H**otels) economy remains depressed and on government life support.

The US Federal Reserve has decided that buying corporate bonds will allow issuers to more easily issue debt[1], and the extra cash would mean fewer layoffs and avert bankruptcies. This is being viewed as a new "Greenspan Put" and has sparked a run in the stock markets. But it also means a collapse of market discipline, since junk bonds will easily find a buyer in the Fed[2]. At some point in future, when these bonds default en masse, there may be problems.

For now, the US stock market party continues. The Fed may even buy stocks directly. This happened elsewhere before: in 1998 the Hong Kong government rescued its stock market by buying a substantial portfolio of index stocks. This was later unwound via an IPO as the Tracker Fund[3]. The Fed may well do likewise.

In any case, central banks elsewhere already hold substantial amounts of equities: Bloomberg reported in June 2019 that central banks worldwide held US$1 trillion of equities, and that one quarter of them planned to further increase their holdings. In May this year, Barron's also reported that the Swiss central bank held shares in Apple, General Electric, and Disney[4].

Despite the recent market recovery, there remain interesting opportunities, and your manager is busy putting money to work.

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

Benjamin Koh
Chief Investment Officer
Lighthouse Advisors
23 August 2020

3. Portfolio Review

As at 30 June 2020, the Net Asset Value (NAV) of the Fund was USD 77.22. Net of all fees, the year-to-date return was -6.7%.

It was a good quarter for the Fund, recovering most of the losses of 1Q 2020. The portfolio

[1] *The Fed bought more blue-chip and junk bonds, and has started making Main Street loans*, **CNBC**, 10 Aug 2020.

[2] *"The Fed Is the Huge Babysitter in the Room": How the Federal Reserve Enabled a Coronavirus Junk Bond Boom*, **Vanity Fair**, 26 Jun 2020.

[3] *Tracker Fund still popular 20 years after Hong Kong government created ETF to dispose of shares bought during 1998 crisis*, **South China Morning Post**, 11 Nov 2019.

[4] *Switzerland's Central Bank Bought Up Apple, GE, and Disney Stock. It Also Loaded Up on a Marijuana Stock*, **Barron's**, 11 May 2020.

restructuring continues, and the new additions have contributed positively. As of the date of this letter in mid-August, the portfolio overhaul has been completed, and only one stock remains from a year ago – the Fund has essentially been reborn.

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	2Q20	1H20
Singapore (STI)	-23.0%	4.4%	-19.6%
Hong Kong (HSI)	-16.3%	3.5%	-13.3%
Shanghai (SSE)	-9.8%	8.5%	-2.1%
USA (NASDAQ)	-14.2%	30.6%	12.1%
Fund	**-18.9%**	**15.0%**	**-6.7%**

25 securities made up 98% 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.

Stock markets experienced a broad rebound off global lows in the second quarter, so a winners/losers tally is again meaningless and will not be shown.

New Investments

Dali Foods is a food and beverages company in China. It produces Western-style snacks such as cookies, and beverages such as energy drinks and soy milk, plus bread, its newest category. In its key categories it is the leader, except in biscuits where it trails **Mondelez** (maker of the *Oreo*), and in chips, where it is third after Frito-Lay (owned by **Pepsi**) and **Orion** (of South Korea).

The shares were acquired at 15 times 2019 earnings, with a yield of over 6%.

Delfi is a consumer goods company focused on chocolate confectionery. Its key brands include *Delfi*, *Silver Queen*, *Goya* and *Van Houten*. Its largest market is Indonesia, followed by the Philippines. It has 2 joint ventures in Indonesia, one with South Korea's **Orion** Corporation (maker of the *Choco Pie*) and another with Japan's Yuraku Confectionery. Its brands have over 50% market share in Indonesia, giving it scale to also distribute over 80 other brands across Indonesia and the region. The shares were acquired at 11 times 2019 earnings and a 4.5% yield.

Frasers Logistics & Commercial Trust owns 99 properties in Singapore, Australia and Europe. The sponsor is **Frasers Properties**, a property conglomerate ultimately controlled by Charoen Sirivadhanabhakdi, a Thai tycoon who made his fortune in spirits and now has extensive interests across real estate as well as alcohol. Aggregate occupancy is over 97%, and lease expiry averages over 5 years.

Key logistics / industrial tenants include **BMW**, **CEVA Logistics**, **Coles Group**, **Schenker Australia**, and **Bosch**. Key commercial tenants include: **Commonwealth of Australia**, **Google**, **Rio Tinto**, **Commonwealth Bank of Australia**, **Fluor**, **Suntory** and **Nokia**. **WeWork** is the only potentially weak tenant, but it is only 3.4% of the commercial portfolio (which is itself less than half of the total portfolio by value).

The units were acquired at 1.1 times book value and paid a 6% yield.

Keppel Pacific Oak US REIT owns 13 office buildings across the United States. It is sponsored by Keppel Capital, a unit of **Keppel Corp** (a Singapore state-owned conglomerate) and KBS Pacific Advisors, whose shareholders co-founded KBS, a US-based commercial real estate manager with US$8 bn under management.

Portfolio occupancy is 94% and average lease expiry is over 5 years. Key tenants include **Ball Aerospace**, Oculus VR (owned by **Facebook**), **Lear**, **Zimmer** and **US Bancorp**.

The units were acquired at 0.9 times book value, with a yield of 8.5%.

Kingsoft is a software company with 3 distinct businesses: office productivity software (*WPS Office*), video games (PC and mobile), and cloud services (*Kingsoft Cloud*).

WPS Office enjoys a 43% market share in China and is provided via subsidiary **Beijing Kingsoft Office Software**, which was listed on the STAR market in November 2019. Kingsoft entered online games in 2003 with *JX Online*. The current sequel *JX Online III* has been running since 2009. The cloud services unit **Kingsoft Cloud** was listed on NASDAQ in May 2020 and deconsolidated thereafter, however Kingsoft retains a 42% stake and remains the largest shareholder.

Kingsoft's CEO and co-founder is Lei Jun, who may be better known as the man behind **Xiaomi**. Lei still owns 12.7% of Kingsoft. Co-founder Pak Kwan Kau, who wrote the original *WPS Office* which launched the company, has 7.9%. **Tencent** holds 7.8%.

Valuing Kingsoft Cloud at market value, and excluding one-off items, the shares were initially bought at about 20 times adjusted 2019 earnings. Yield was *de minimis* at 0.4%.

Kweichow Moutai is the world's largest distiller. It produces *baijiu* (白酒), a spirit made from sorghum. In China, Moutai is the drink of choice at social occasions, from wedding banquets to corporate functions. As China's economy has grown, so has demand for Moutai, but supply has not kept pace, resulting in price increases which have made it even more desirable.

What distinguishes Moutai from other *baijiu* brands is the enormous markup distributors earn: as much as 100% over wholesale. This creates challenges (employees who award Moutai franchises are prime bribe targets, and the chairman himself was arrested in 2018) but also opportunities (by selling direct to large customers, the company can reclaim some of the spread earned by franchisees).

The shares were purchased at 36 times 2019 earnings, with a minimal 1% yield.

Manulife US REIT is a real estate investment trust which owns 9 "Trophy / Class A" office buildings across the United States. Occupancy averages 97% and leases average 6 years, with annual rent escalations of 1.9%. Tenants include blue-chip entities such as the **US Treasury**, the **United Nations**, **Hyundai**, **Amazon** and **Chubb**.

The REIT is sponsored by **Manulife**, the largest insurer in Canada. Manulife traces its history back to 1887 and today manages USD 881 bn under management, including USD 18.5 bn in real estate holdings.

The units were acquired at 0.9 times book value and paid a 7.6% yield.

Prime US REIT is a real estate investment trust which owns 12 Class A office buildings across 10 markets in the United States. It is sponsored by KAP, whose shareholders founded KBS, a US-based commercial real estate manager with US$8 bn under management.

Occupancy is 95%, and lease expiry averages 5 years. The top ten tenants include **Charter Communications**, **Goldman Sachs**, **Sodexo**, **Wells Fargo Bank**, and the **State of California**. **WeWork** is the only potentially problematic tenant, but it accounts for only 2.3% of the portfolio rent.

The units were acquired at 0.9 times book value and yielded over 9%.

Want Want China is the largest manufacturer of rice snacks and flavoured milk in China. Its key brands are *Want Want* （旺旺）crackers and *Hot Kid* (旺仔) milk. The company was founded in Taiwan in 1962 and began producing rice crackers in 1983. It entered the flavoured milk business in 1996. The founding Tsai family still holds a 50.7% stake.

The shares were bought at about 18 times FY20 earnings, with a 4% yield.

Divestments

Convenience Retail Asia was sold due to concerns over the ongoing unrest in Hong Kong. After including dividends received, the loss on divestment was about 9%.

Genting HK was sold due to concerns over a prolonged recovery given that the cruise industry has essentially shut down due to the pandemic. Loss on exit was about 72%.

Greatview Aseptic was sold over concerns about price erosion due to consolidation in the Chinese dairy sector. Including dividends received, loss on divestment was about 9%.

IT was sold due to concerns over unrest in Hong Kong and a retail slowdown in China. After dividends, loss on sale was about 29%.

Keppel Corp was sold due to concerns over poor upcoming results due to low oil prices, as well Temasek possibly withdrawing its partial offer. Loss on divestment was about 15%.

Luk Fook was sold due to concerns over the ongoing unrest in Hong Kong. The loss on divestment was about 22%.

Netlink was sold to free up capital for more attractive ideas. After distributions received, gain on divestment was 10%.

Pico Far East was sold on concerns that the pandemic shutting down large-scale events would cause an almost total loss of business for the company. Including dividends, the loss on exit was about 5%.

SAIC Motor was sold on concerns that poor economic conditions in China would persist and affect demand for cars. After dividends, loss on sale was about 4%.

Other Developments

Nil.

4. Choose Your Parents Wisely

"Choose Your Parents Wisely": an article in the 25 Jul 2014 edition of *The Economist* explored the class divide in America through the lens of 2 families: an upper-income one versus a low-income one. It made what is already intuitive abundantly clear: the gap in parental resources results in vastly different outcomes for the children in each family.

So too, in the corporate world, do parents influence the lives of their children. Strong corporate parents can start their children off on a sound footing, with little or no debt and plenty of good assets. Weaker parents are not so fortunate: they spin off subsidiaries because they cannot afford to support them further, they may make poor choices on behalf of their children, and the children may come to market too small, too hungry for capital, and with debt already weighing them down. In a worst-case scenario, less altruistic parents may saddle their offspring with more than their fair share of burdens, or even earn unfair profits at the expense of their children.

Many real estate investment trusts (REITs) are created by owners to offload mature assets in order to recycle capital from lower-yielding investment properties into higher-yielding projects. Case studies abound. The following illustrate just how critical REIT parentage can be.

Ascendas REIT (A-REIT) was created in 2002 from buildings developed by Ascendas, a corporation originally wholly-owned by the Singapore government. Under Ascendas, the buildings were managed as part of an overarching national strategy to provide a supportive environment for industries. Rent maximization was not the primary goal.

Therefore, when A-REIT was created, the inherited rental contracts were sometimes at below-market rates. This was especially true in the high-tech business parks, which were essentially office buildings but zoned as "light industry", allowing desirable tenants like

software developers to pay pseudo-industrial rents for office-type space.

As a result, for several years after listing, A-REIT was able to raise rents annually without too much complaint, until its rents were on par with the market. The following table makes clear just how big the gap was during the "catch-up" period:

Year ending 31 Mar	Distribution per unit	% Change
FY04	8.160	
FY05	9.560	17.2%
FY06	11.680	22.2%
FY07	12.750	9.2%
FY08	14.130	10.8%
FY09	15.180	7.4%
FY10	13.100	-13.7%
FY11	13.230	1.0%
FY12	13.560	2.5%
FY13	13.740	1.3%
FY14	14.240	3.6%
FY15	14.600	2.5%
FY16	15.350	5.1%
FY17	15.743	2.6%
FY18	15.988	1.6%
FY19	16.035	0.3%

2008-2009 spanned the global financial crisis, and clearly forced a reset of rents. Once at market rates, rental reversions (as measured by distributions per unit) were clearly far more modest. Still, for a good 5 years, unitholders enjoyed market-beating returns.

Essentially, the Singapore government gave A-REIT a huge "starting out" gift. Of course, there was a larger agenda: the government wanted to create a pool of REITs trading in Singapore, to give its financial markets a boost. A-REIT, as the industrial REIT pioneer, had to put on a good show, which it did.

The government's gambit worked fantastically well: from just 2 REITs (Capitamall Trust and Ascendas REIT) with a combined market capitalization of S$1.2 bn in 2002, as of April 2020 there were 43 REITs trading on the Singapore Exchange with a total market capitalization of over S$100 bn, accounting for over 12% of total stock market capitalization. Singapore is now the third-largest REIT centre in the Asia Pacific, trailing only Japan and Australia, which have much larger stock markets. So it was a huge win-win, for both unitholders and the government alike.

Soilbuild Business Space REIT (SB-REIT) appears similar to A-REIT at first glance: a mix of business parks and light industrial buildings. The IPO prospectus from 2013 lists some blue-chip tenants like **Spring Singapore** (a Singapore government statutory board), **Ubisoft**, **Nestle**, **Dyson** and **Hitachi**.

Like A-REIT, SB-REIT was created from buildings developed by its parent, in this case **Soilbuild Group**, a privately owned property developer. (In fact, Soilbuild itself went public in 2004, but it was delisted in 2010 and subsequently opted to spin off its investment properties as SB-REIT.)

However, the distribution history since IPO has been far less impressive:

Year ending 31 Dec	Distribution per unit	% Change
2014	6.193	
2015	6.487	4.7%
2016	6.091	-6.1%
2017	5.712	-6.2%
2018	5.284	-7.5%
2019	4.220	-20.1%

Compared with A-REIT which posted low single-digit increases in distributions annually during FY14-FY19, SB-REIT distributions fell by high single-digit percentages nearly every year, and in 2019 they sank 20%. This was blamed on a default by a large tenant, NK Ingredients (7% of 2018 net property income). But this was not the first big default: in 2016 its third largest tenant, Technics Offshore (11% of net property income) also defaulted.

It is not that SB-REIT did not have any "good tenants" – the 2019 annual report does list the **Commonwealth of Australia**, **Autodesk**, **Ubisoft** and **Nestle** among its key tenants. But the worst that happens with "good tenants" is non-renewal of their lease, which is part of normal tenant turnover. But "bad tenants" can

and do default, and the ability to avoid bad tenants is what separates one landlord from another.

Clearly, since it could not raise distributions for any meaningful period of time, SBREIT did *not* get a "starting out" gift of below-market rental contracts from its parent company. Instead, it seems like it was handed some tenants who were below-market in quality, as evidenced by the defaults and the consequent declines in distributions.

Sabana Shari'ah Compliant REIT (Sabana REIT) was listed in 2010. It held 15 industrial properties comprising a mix of high-tech buildings, chemical warehouses, standard warehouses, and general industrial buildings.

Sabana REIT tried to tap a different pool of capital: Shari'ah investors. Perhaps the hope was that the scarcity of Shari'ah compliant instruments would let it trade at lower yields, lowering its cost of capital for acquisitions. Its actual distributions tell a sad tale:

Year ending 31 Dec	Distribution per unit	% Change
2012	9.28	
2013	9.38	1.1%
2014	7.33	-21.9%
2015	6.85	-6.5%
2016	4.64	-32.3%
2017	3.31	-28.7%
2018	3.18	-3.9%
2019	2.92	-8.2%

Given what was discussed about SB-REIT, such large and sustained declines in Sabana REIT's distributions might imply widespread defaults across the portfolio. What happened?

The IPO prospectus reveals that at launch, all the properties save one were under master leases. The REIT owned 23 properties over the years, starting with 15 in 2010, then acquiring 6 in 2012, 1 in 2013 and 1 in 2015.

As of 31 Dec 2019, compared with the original cost, 11 properties had impairments of over 20%, and 7 were impaired by over 33%. This is an extremely poor batting average. No REIT manager gets acquisitions right all the time, but getting it so badly wrong so many times points to a more serious issue.

The master leases hold the answer. Most of the buildings were acquired via sale-leaseback transactions where the owner-occupants agreed to pay agreed-upon rents for a few years. If the rents were above-market, this then implied above-market prices for the buildings. The REIT's valuers were happy to sign off on the deals without proper due diligence on whether the rents were justified. When said leases expired, the lessees demanded a reset of rents to market rates, which in turn forced the REIT to write down the value of the buildings.

The inflated leases were typically 3-5 years long. Once they ran out, the game was over. Of the 15 buildings the REIT owned at launch, 7 were impaired exactly 5 years after IPO. The aggregate loss was 19%. The REIT acquired another 6 buildings in its second year of listing; one was impaired by 13% just 2 years later, while another was written down 22% after 3 years. Unsurprisingly, both had been master-leased back to the vendors for 3 years.

So the problem for Sabana REIT was not that tenants defaulted, but that it substantially overpaid for nearly half of its buildings. What was the REIT manager up to?

Normally, the REIT manager is expected to own a substantial percentage of the REIT to ensure alignment of interest, but in this case it only owned a 4% stake.

In fact, the Sponsor, **Vibrant Group** (then known as **Freight Links**), owns 51% of the REIT manager. It seeded the IPO portfolio with 5 of the 15 properties, but instead of merely transferring the buildings with their normal leases attached, *it inserted itself as a master lessee between the REIT and the underlying tenants.* The effect was to inflate the rents paid, and thus the market value of the properties.

Vibrant is also a listed company, and its own circular to its shareholders in 2010 outlining

the sale-leaseback transactions is telling. It carried the 5 buildings on its own books at S$91m, but would be selling them to the REIT for S$193m. Granted, the buildings were valued at cost less depreciation, but even at original cost, they totaled just S$137m.

Of the 5 buildings Vibrant / Freight Links sold to the REIT, 4 of them remained in the portfolio 9 years later. The REIT paid $179.5m for them in 2010. As of 31 Dec 2019, they were valued at $138.7m, a loss of 23%.

So the REIT manager was merely continuing the trend the Sponsor had set in place from the start: sell and lease-back buildings to the REIT, and let unitholders take the hit when rents revert to market rates.

EC World REIT went public in 2016. It holds 6 industrial properties in Hangzhou, China, consisting of ports, warehouses and adjacent office buildings.

Year ending 31 Dec	Distribution per unit	% Change
2017	6.025	
2018	6.179	2.6%
2019	6.047	-2.1%

The REIT has been listed for only 4 years, so the distribution history tells us little. Perhaps a look at the tenants may be more informative.

Top 10 tenants as per the 2019 annual report:

	Top tenants	% of gross rent
1	杭州富港供应链有限公司 Hangzhou Fu Gang Supply Chain Co., Ltd.	34.9
2	富春集团控股有限公司 Forchn Holdings Group Co., Ltd	22.3
3	杭州富阳运同电子商务有限公司 Hangzhou Fuyang Yunton E-commerce Co., Ltd	20.5
4	浙江中烟工业有限责任公司 China Tobacco Zhejiang Industrial Co., Ltd	12.1
5	浙江运通电子商务有限公司 Zhejiang Yuntong E-commerce Co., Ltd	3.9
6	当当网信息技术（眉山）有限公司 Dangdang Information Technology	1.2
7	网赢供应链有限公司 Wangying supply chain Co., Ltd	1.0
8	杭州西联物流有限公司 Hangzhou Xi Lian Logistics Co., Ltd	1.0
9	浙江高阳物资有限公司 Zhejiang Gao Yang Supplies Co., Ltd	0.6
10	湖北京邦达供应链科技有限公司 Hubei Jingbangda Supply Chain Techonology	0.4

At a glance, there is already cause for concern: the sponsor is **Forchn Holdings**, and they are the second-largest tenant, accounting for 22% of the rent, creating a conflict of interest. But it gets worse: **Hangzhou Fu Gang Supply Chain Co., Ltd**, the largest tenant, is a subsidiary of Forchn Holdings, and **Hangzhou Fuyang Yunton E-commerce Co., Ltd**, the third-largest tenant, is *also* a subsidiary of Forchn Holdings.

In total, the Sponsor accounted for 78% of the REIT's rent in 2019. The Sponsor only owns about 40% of the REIT, creating a moral hazard: in a crisis, it might choose to default on its rental obligations to protect itself, at the expense of unitholders. So far, nothing of that sort has happened. But the case of **Sabana REIT** should be a cautionary tale for investors who encounter REIT-Sponsor master leases.

In conclusion, when evaluating a REIT, investors should take parentage into account. By and large, good parents raise good children. Mediocre parents… have less success. As for parents who take advantage of their children, the problems are self-evident.

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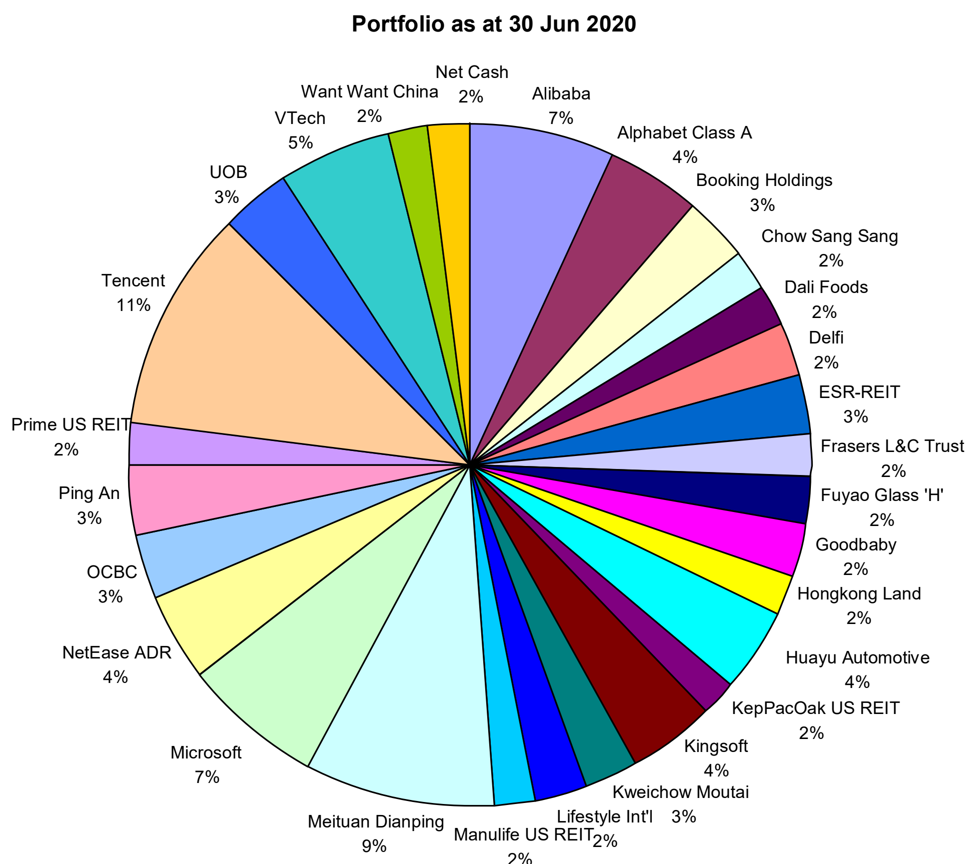
LIGHTHOUSE ADVISORS

Keeping Your Capital Safe

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	71.23	70.50	77.22							**-6.7%**

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.