LIGHTHOUSE ADVISORS

Keeping Your Capital Safe

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Client Newsletter for the period ended 30 Sep 2020

Welcome to the Lighthouse Advisors newsletter for September 2020. In response to client feedback, the structure of the newsletter has been changed.

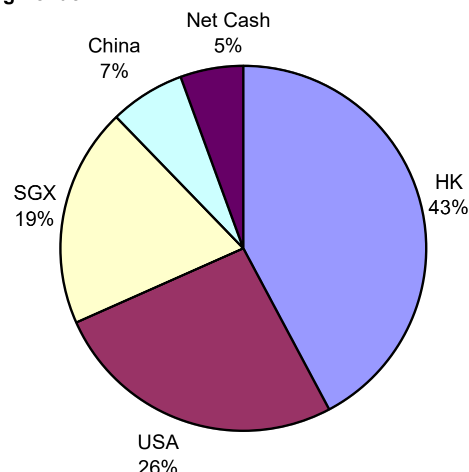
1. **Summary**
2. **Market Commentary**
3. **Portfolio Review**
4. **In Sickness and In Health**

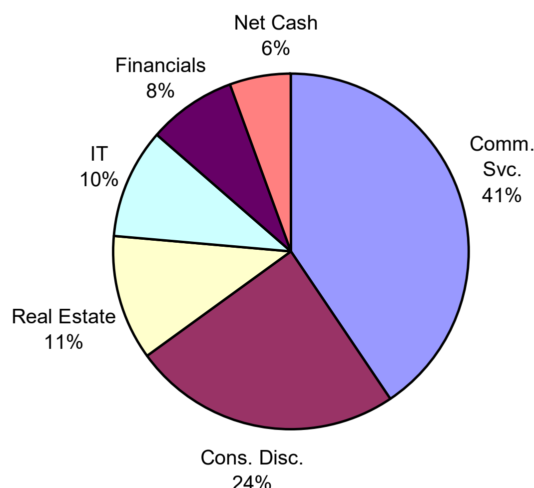
1. Summary

The estimated NAV for September 2020 was USD 85.00 (SGD: 116.47), subject to final confirmation by the Fund Administrator. YTD return in USD was +2.7% (SGD: +4.6%).

Market (Index)	1Q20	2Q20	3Q20	9M20
Singapore (STI)	-23.0%	4.4%	-4.8%	-23.5%
Hong Kong (HSI)	-16.3%	3.5%	-4.0%	-16.8%
Shanghai (SSE)	-9.8%	8.5%	7.8%	5.5%
USA (NASDAQ)	-14.2%	30.6%	11.0%	24.5%
Fund	**-18.9%**	**15.0%**	**10.1%**	**+2.7%**

23 securities made up 95% of the Fund's holdings, with the balance in cash and cash equivalents. The following charts show the approximate exposure by place of listing and sector (numbers may not add up or match exactly due to rounding).





A detailed chart of holdings is in Annex I, while NAV values in both USD and SGD are tabled in Annex II.

Updated 12 Oct 2020

2. Market Commentary

Low interest rates continue to fuel inflows into stock markets worldwide. However, the buying has not been totally indiscriminate; despite the sums pouring into index funds, the dispersion of returns between winners and losers even within indices has been enormous: the five largest components of the S&P 500 (Apple, Amazon, Facebook, Microsoft and Alphabet, collectively "S&P 5") have massively outperformed the other 495 stocks.

Commentators have noted at various points that excluding the S&P 5, the S&P 500 would be *down* for the year. In other words, 1% of the stocks (comprising about 29% of the weight) made up over 100% of the return. **Stock selection matters!**

The markets continue to present interesting opportunities. The Fund has received some inflows recently, and your manager is putting money to work.

The next newsletter will be written for the period ending 31 December 2020.

Benjamin Koh
Chief Investment Officer
Lighthouse Advisors
12 October 2020

3. Portfolio Review

It was another good quarter for the Fund, with the Fund now slightly up for the year.

New Investments

Expedia is the world's second-largest online travel agency by revenue. Long viewed as inefficiently-run versus archrival **Booking**, the pandemic has forced a restructuring. Realized savings so far amount to US$500m annually, significant versus its 2019 operating earnings of US$903m. When travel resumes, it should be able to capitalize on the demand.

The shares were acquired at 26 times 2019 earnings, with a yield of 1.4%.

Inner Mongolia Yili Industrial is the largest dairy products company in China. Sales were disrupted by the pandemic in the first quarter but have since recovered, with first half results down by only 1.2%. Longer-term, profits are expected to be driven by both market share gains (improving efficiency) as well as Chinese consumers upgrading to more expensive items (higher gross margins).

The shares were acquired at 30 times 2019 earnings and a 2% yield.

Nexon makes massively multiplayer online role-playing games (MMORPGs). Its 2 biggest games are *Dungeon and Fighter* (*DNF*) and *Maple Story*, which have been running since 2005 and 2003 respectively. Nexon is headquartered in Japan, but its main markets are China and Korea.

The games industry is hits-driven, but Nexon focuses on long-lived franchises to maximize the value of its players. For context, *DNF* has grossed more money in its 15-year life than most movie franchises, out-earning the box-office takings of *Star Wars*, *Harry Potter* and *James Bond*. The only movie franchise that has beaten *DNF* is Disney's Marvel Cinematic Universe – which comprises 28(!) movies.

Covid-19 has kept people indoors and playing more games, so Nexon benefits. *Maple Story* was also recently updated, and even before the pandemic, *Maple Story* revenues were increasing at triple-digit rates.

The shares were bought at about 20 times 2019 earnings, with a *de minimis* 0.1% yield.

Tongcheng-Elong is the third-largest online travel agent in China, behind **Meituan Dianping** and **Trip.com** (its largest shareholder). It is the sole operator of the "Rail and Flight" and "Hotel" portals in *WeChat*, the super app owned by **Tencent.**

Tencent is the second-largest shareholder of both Meituan Dianping and Tongcheng-Elong, so all 4 parties are inter-linked. While the authorities will frown on cartelization, a price

war is unlikely as the market has consolidated. Healthy (profitable) competition should be the status quo, though Trip.com might try to buy Tongcheng-Elong.

The pandemic is under control in China, and normal life has resumed, with air and hotel bookings recovering to pre-pandemic levels.

The units were purchased at 19 times adjusted 2019 earnings. There is no dividend.

Divestments

Chow Sang Sang was sold on concerns about fewer Chinese shoppers and the ongoing unrest in Hong Kong. After adding dividends received, the result was flat.

ESR REIT was sold due to concerns over the poor industrial outlook and likely rental declines. Including distributions, gain on exit was about 31%.

Fuyao Glass was sold due to the decline in the Chinese auto market. After dividends, the final shares were sold for a gain of 55%.

Goodbaby was sold after persistent poor operating performance. Loss on sale was 68%.

Hongkong Land was sold on concerns about the ongoing unrest in Hong Kong and to free up capital for other ideas. After dividends, the loss on sale was about 29%.

Huayu Automotive was sold due to the decline in the Chinese auto market. After dividends, the last shares were sold for a gain of 38%.

Lifestyle International was sold due to declines in Chinese shoppers amid the ongoing unrest in Hong Kong. Loss on exit was about 28%.

VTech was sold to free up capital for more attractive ideas. After dividends, loss on divestment was about 34%.

Other Developments

Nil.

4. In Sickness and In Health

Healthcare Real Estate Investment Trusts (REITs) are specialized REITs, owning hospitals, nursing homes, senior/assisted living properties and other healthcare-related facilities. These should be highly attractive assets, since demand for healthcare is usually considered to be stable and inelastic, which means the operators should enjoy steady cash flows, making them ideal tenants. Yet, a closer look suggests things are not so wonderful.

Through their property managers, REITs can evict and replace tenants who are in arrears. In commercial and industrial buildings, fittings are generally modest and easily removed to make way for new tenants. For hospitality assets, new operators can be appointed without any changes except for the brand on the signage and bedding. But in healthcare, the balance of power is reversed.

When changing operators, staff can be recruited elsewhere, or even hired from the outgoing operator, but the transition to the new operator's IT systems necessitates a risk of loss or mix-up of patient records. Any mishaps, especially deaths, would be a public relations disaster. As a result, when a healthcare operator has financial difficulties, the landlord may have no choice but to share the pain, because changing to a new operator is even more costly and risky. The change may not even be allowed by the regulator, in order to protect the patients. The healthcare license could even be tied to a specific operator at a specific facility.

The healthcare REIT is therefore not a traditional landlord in the sense of a senior secured creditor, who effectively holds the tenant's ability to operate as collateral, but a junior unsecured lender, who is entitled only to a fixed payment and is subordinate to the tenant's operating needs. When the operator

does well, it pays the REIT its dues, and keeps the surplus. When it does poorly, the REIT must cut its rent to save the operator. **Heads the operator wins, tails the REIT loses.**

Below are examples both past and present.

Omega Healthcare Investors is the largest US REIT focused on skilled nursing facilities. Changes in government reimbursement rates caused its tenants difficulties in 2018. Omega was forced to bail them out, not just via rent cuts of 11-25%, but also *loans* to help repay other lenders and for working capital.

The aid to **Signature Healthcare**, one of the tenants, reads like every landlord's nightmare:

(i) US$6.3m of rent deferral for 3 years;

(ii) Capex funding of US$4.5m per year for 3 years;

(iii) Working capital loan of up to US$25m at 7%, maturing in 2025;

(iv) Lease extension of 2 years to 2030; and

(v) Existing term loan extension of 2 years to 2024

Horrible does not begin to describe the deal for Omega. But was Omega merely unlucky, as its tenants were dependent on government reimbursements and faced regulatory risk? What about REITs that own private facilities, where payments come directly from customers, not the government?

Ventas is the second largest US healthcare REIT. About half of its income comes from privately-paid senior housing. This should have insulated it from regulatory changes.

In 2018, Ventas' tenant **Brookdale Senior Living** also ran into problems. Ventas was forced to help Brookdale by signing a new lease which cut rents by US$6m per year and reduced the annual rent escalations.

As it turns out, that deal wasn't enough, and in July 2020 Ventas rescued Brookdale again:

(i) Rent reductions of US$500m over 5 years; and

(ii) Loan of US$45m to Brookdale.

In exchange, Ventas got:

(i) US$47m of forfeited security deposits;

(ii) US$115m in fees;

(iii) Five properties as repayment for a prior US$78m loan; and

(iv) Warrants to buy 16.3m Brookdale shares at US$3, valid till 2025.

Obviously, Omega and Ventas would prefer tenants to operate normally and pay the rent. **No landlord willingly lends money to tenants.** If the buildings had been offices, factories, warehouses or even hotels, the property owner would have simply given notice and found new tenants/operators with minimal downtime.

The final case study sits closer to home. **First REIT** was listed on the Singapore Exchange in December 2006. Its sponsor is **Lippo Karawaci**, an Indonesian real estate conglomerate controlled by the **Riady** family.

At IPO, First REIT owned 3 hospitals and a hotel, all in Indonesia. In later years, First REIT acquired additional assets, but the 2019 annual report shows Indonesia still accounted for 96% of rents.

Since IPO, substantially all the income has come from facilities operated by Siloam Hospitals, a unit of Lippo Karawaci. As it happens, Siloam Hospitals itself went public in 2013. The following table shows the rent paid by Siloam Hospitals from 2012 through 2019, converted using the year-end mid-market exchange rates, and the net property income (NPI) reported by First REIT for its Indonesia segment.

Year	Siloam Hosp. Rent Paid IDR bn	Yr-End IDR vs. SGD FX Rate	Siloam Hosp. Rent Paid SGD mn	First REIT Indonesia NPI SGD mn
2012	30.3	8,022	3.8	52.3
2013	40.9	9,634	4.2	77.3
2014	66.3	9,381	7.1	88.4
2015	104.5	9,760	10.7	95.4
2016	150.8	9,327	16.2	101.7
2017	192.2	10,149	18.9	105.5
2018	233.4	10,561	22.1	110.8
2019	252.7	10,326	24.47	109.2
Total	**1,071.0**		**107.5**	**740.6**

Obviously, Siloam never paid much of the rent First REIT received. Instead, Lippo Karawaci (the master lessee) topped up the difference. The gap is massive in both relative and absolute terms. Over the 8 years studied, Siloam paid only 14.5% of the rent the REIT reported receiving. Lippo Karawaci's subsidies totaled SGD 633.1m.

Why did Lippo Karawaci subsidize First REIT to such an extent? The answer is that most of the REIT's hospitals were bought from Lippo Karawaci, and purchase prices depended on the rent. **Higher rents meant higher prices.**

Year	Sponsor Assets acquired (SGD mn)
2010	205.5
2012	142.9
2013	190.4
2015	70.0
2016	20.0
2017	55.5
Total	**684.3**

The total assets sold by Lippo Karawaci to First REIT exceeded the subsidies provided during 2012-2019. Until 2018, Lippo Karawaci also owned about 1/3 of First REIT, so adding its share of distributions, it came out comfortably ahead.

Initially, this was a virtuous cycle. Lippo Karawaci sold hospitals to the REIT at inflated prices, then used some of the proceeds to pay inflated rents. It also recovered some of the overpayments through its ownership of First REIT units. Retail investors were either happy to go along with the charade, or blissfully ignorant of what was really going on.

But nothing lasts forever. In 2018, Lippo Karawaci ran into problems with its Meikarta city project on the outskirts of Jakarta. It was sued over non-payments by partners who helped created and marketed ads for Meikarta. Lippo Karawaci needed money, so it sold some assets to… itself.

To be exact, Lippo Karawaci sold its stake in the REIT manager to OUE (69% owned) and OUE Lippo Healthcare (OUE LH, 64% owned by OUE). 10.6% of First REIT units were also sold to OUE LH, and it disposed of the rest.

OUE LH conducted a rights issue to buy the REIT manager and the REIT units, but post-rights it still carried over S$300m of debt. It needed the REIT distributions to help service its debt and had no spare cash to upstream to OUE for onward distribution to Lippo. Effectively, after the deal, Lippo had no way to recover the subsidies to First REIT.

In June 2020, Lippo Karawaci issued a press release entitled *Covid-19 Renders Rental Subsidies Unsustainable; LPKR To Initiate Restructuring Discussions On Leases with First REIT*. But the fact is that selling off the First REIT manager and the First REIT units in 2018 had already rendered the subsidies unsustainable, long before Covid-19.

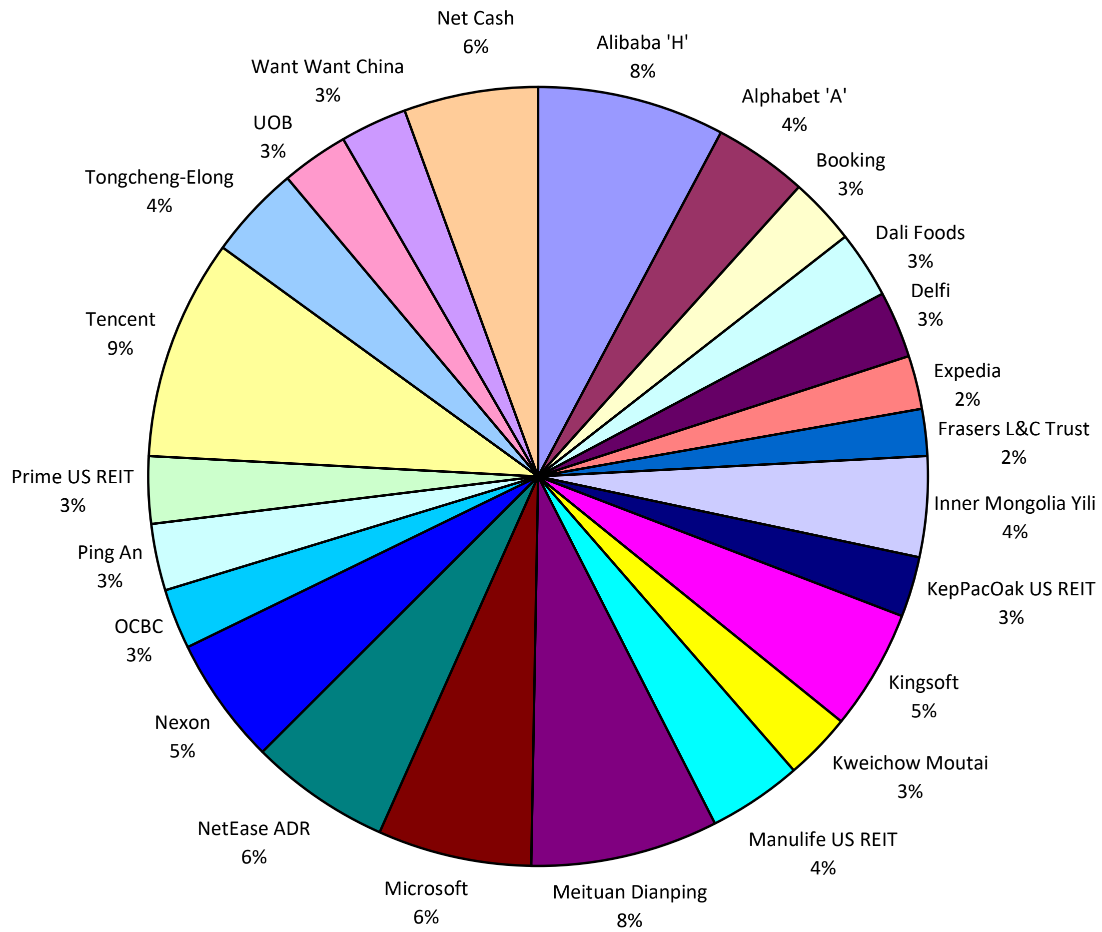
What happened to Omega and Ventas do not bode well for First REIT. In fact, First REIT foreshadows this with its Korean property, Sarang Hospital. Sarang was bought in 2011. The lessee defaulted just 2 years later. Since then, it has paid full rent only in 2016. First REIT has not changed Sarang's operator despite persistent arrears, which hints at just how difficult the process is. It is unlikely to be any easier with the Siloam hospitals in Indonesia. One can only wish First REIT unitholders the best of luck. Certainly it would be folly to expect a happy outcome.

To conclude, healthcare REITs are captive landlords beholden to their tenants, not the

other way around. Conservative investors should reconsider whether they are worth the extra risk, especially when such REITs often trade at lower yields on account of the supposed stability of the healthcare sector. **More risk, less return**: hardly a sound recipe for investment success.

☙ End ❧

Annex I



Updated 12 Oct 2020

Annex II

NAV in USD (Official)

	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	82.23	88.36	85.00*				**+2.7%**

**subject to confirmation by the Fund Administrator*

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.

The following data is for the convenience of SGD-based investors and is for reference only.

NAV in SGD (for reference only)

	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	YTD
2008										50.68	50.69	51.20	**2.4%**
2009	52.22	51.91	50.74	54.21	66.70	66.59	72.06	71.60	74.19	75.67	78.50	84.15	**64.4%**
2010	83.11	85.83	91.17	93.55	89.79	91.72	96.10	97.84	106.70	108.12	112.34	115.86	**37.7%**
2011	111.57	109.76	111.06	113.64	112.11	112.14	109.75	100.70	89.85	97.91	93.64	94.48	**-18.5%**
2012	97.39	103.46	103.79	103.05	98.44	97.76	96.12	97.20	98.89	96.95	100.95	103.74	**9.8%**
2013	113.19	120.44	124.03	123.50	125.34	120.54	125.55	127.49	126.57	126.83	128.86	127.81	**23.2%**
2014	124.51	128.55	125.58	127.84	132.26	132.85	135.95	135.58	132.14	133.61	132.91	132.34	**3.5%**
2015	132.68	133.74	134.11	137.66	139.74	136.08	131.71	121.30	119.78	124.68	121.53	122.26	**-7.6%**
2016	116.13	117.82	119.59	123.86	126.08	123.36	126.71	129.30	129.32	129.95	131.79	130.54	**6.8%**
2017	131.35	135.81	141.22	141.04	146.29	147.44	148.75	147.28	149.30	153.38	146.00	146.32	**12.1%**
2018	148.13	145.04	142.95	139.64	146.74	142.24	137.76	128.59	128.83	117.98	119.13	118.06	**-19.3%**
2019	123.77	124.86	123.01	122.81	113.88	113.93	113.02	108.85	105.83	105.92	107.71	111.33	**-5.7%**
2020	107.23	105.02	95.47	100.41	99.64	107.68	112.93	120.20	116.47				**+4.6%**