

Client Newsletter for the period ended
30 June 2015

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1. Foreword

Fellow Investors,

Welcome to the Lighthouse Advisors newsletter for June 2015.

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

2. Market Commentary

The big news of the last few months is undoubtedly the economic collapse of Greece, dubbed “Grexit” for the possibility that Greece may leave the Eurozone.

In a referendum conducted on 5 July, 61% of Greek voters said “no” to the aid package proposed by creditors on June 25. The consequences of the “no” vote soon became apparent as Greek banks shut their doors to avoid running out of cash, capital controls were implemented, and ATM withdrawals were limited to €60 per day. Spooked, Greek Prime Minister Alexis Tsipras executed an about-face and pushed through legislative reforms even harsher than the package the voters rejected¹.

Still, not everyone thinks the new deal will be enough. The IMF, for one, believes that further debt relief is necessary. While the IMF has estimated that an additional €85bn of aid

¹ *The Troika Returns to Athens as Cowed Tsipras Submits to Demands*, **Bloomberg Business News**, 24 July 2015

will be needed over the next 3 years, until end-2018, Christian Lagarde, its managing director, has also stated that any Greek rescue will not be viable without debt relief.²

Although Greece only accounts for 2% of European GDP, second-order effects are important: Portugal, Ireland and Spain all implemented painful austerity measures in exchange for the financial aid that they received. Ireland exited its bailout in late 2013, followed by Spain in early 2014, then Portugal in mid-2014.

If Greece gets debt haircuts to help it survive, it is only logical for Portugal, Ireland and Spain to demand the same. In fact, they might ask for *bigger* haircuts as a reward for good behavior; otherwise, what would be the point of suffering obediently if you could be like Greece and get more help by behaving badly?

Germany, being the largest contributor to the European Central Bank, would bear the brunt of the haircuts. But the Germans have already lived through 25 years of an extra “solidarity tax” to pay for the rebuilding and integration of East Germany, and they are still not done. It remains to be seen if Chancellor Angela Merkel can convince her compatriots to sign up for another few decades of paying extra taxes, this time to keep Europe afloat.

Currently, the earliest that Germans can retire is 63, whereas until recent reforms many Greeks could retire as early as age 55. So Germans are working harder and retiring later, so that Greeks can collect their pensions earlier. Obviously, Greeks do not view things the same way, especially when 45% of Greek pensioners already receive monthly payments that are below the official poverty line of €665³, but the facts are what they are.

² *IMF defends decision to go public on case for Greece debt relief*, **Financial Times**, 17 July 2015

³ *A Greek paradox: many elderly are broke despite costly pensions*, **Reuters**, 16 July 2015

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“We stand today at a crossroads: One path leads to despair and utter hopelessness. The other leads to total extinction. Let us hope we have the wisdom to make the right choice.”

- Woody Allen

In China, as your manager warned in the last newsletter, the high valuations have come home to roost. From mid-June through early July, the stock markets went into freefall. Both the Shanghai and Shenzhen indices fell more than 20% from their peaks, entering official bear market territory.

Despite the numerous warnings from internal and external observers alike, the speed of the decline appeared to have caught the Chinese Communist Party off-guard, with several rules enacted to encourage *more* speculation, such as allowing stockbrokers to issue short-term bonds, and easing collateral rules on margin financing⁴. Draft rules were unveiled to allow pension funds to invest up to 30% of their estimated RMB 2 trillion of assets into stocks, and 21 stockbrokers set up a RMB 120 billion fund to buy into the stock market.

The China Securities Regulatory Commission (CSRC) announced it would boost the capital base of the government-backed margin finance agency, China Securities Finance (CSF), from RMB 24 billion to RMB 100 billion⁵. This will let CSF to lend more money to stockbrokers for margin financing, although the stock market decline suggests that total margin loans are likely to fall instead. Pension funds were told that they could buy but not sell shares. The CSRC even banned directors, executives and substantial shareholders from selling their shares for 6 months⁶.

⁴ *China Intensifies Steps to End \$3.2 Trillion Stock Rout*, **Bloomberg News**, 5 July 2015

⁵ *China's central bank to fund margin finance agency in latest stock market bailout bid*, **South China Morning Post**, 5 July 2015

⁶ *China Bans Stock Sales by Major Shareholders for 6 months*, **Bloomberg News**, 8 July 2015

About 1,300 companies in Shanghai and Shenzhen, comprising about 45% of all listings, simply halted trading in their shares⁷, citing “significant issues”, a term usually used to refer to restructuring or major transactions. Trading halts can last up to 3 months, so it is possible they were used to sit out the sell-off.

These stopgap measures seem to have stemmed the bleeding for now: the benchmark Shanghai Composite has bounced off a bottom of about 3,500, while the Shenzhen Composite has bottomed at about 1,900.

Volatility is extreme: about 80% of the turnover in the Chinese stock market is attributed to retail investors, and just as it can be boosted to dizzy heights by unjustified optimism, so can it be sold down in sudden panic. Daily turnover is almost RMB 2 trillion, so even if the pension funds and the stockbrokers invested all their allotted money at once, it would be consumed in less than half a day's trading. In other words, if the Chinese people want out of the stock market, it is going *down*, period.

Given the still-unhealthy valuations present in the Shanghai and Shenzhen markets, the Chinese government's attempts to prop up the markets are unlikely to end well. At best it will allow some retail investors to exit, but it will be essentially replacing such retail money with public funds.

While some may compare the Chinese government's efforts to stabilization funds launched by other governments, such as Korea (1990), Taiwan (2000) and Hong Kong (1998), Hong Kong is the only case where the stabilization fund is considered to have succeeded. Furthermore, the Hong Kong fund was buying at a time when the market was depressed in the wake of the 1997 Asian financial crisis. Buying low makes it a lot easier to do well. Unfortunately, the Chinese stock market is currently not depressed by any reasonable measure.

⁷ *China stock market freezing up as sell-off gathers pace*, **Reuters**, 8 July 2015

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Closer to home, the 1 Malaysia Development Berhad (1MDB) saga is threatening to sink Malaysian Prime Minister Najib Abdul Razak. The *Wall Street Journal* obtained documents that showed nearly US\$700m had been transferred into personal bank accounts in Najib's name⁸. The *Journal* also released redacted versions of the documents online. Najib has not denied the existence of the accounts or the transfers, saying only that he has "never taken funds for personal gain", which then begs the further question of who the eventual recipients of the US\$700m were.

Malaysian business weekly *The Edge* also published an exposé documenting how 1MDB was defrauded of US\$1.8bn⁹. Among the transactions flagged was a US\$700m transfer to repay a non-existent loan. The money was not even paid to the supposed lender PetroSaudi Holdings, but instead to a company controlled by Low Taek Jho, a friend of Najib's stepson. US\$529m was later transferred to a company owned by Low.

So far, the Malaysian authorities have arrested various individuals, frozen some bank accounts and even suspended the publishing permit of *The Edge*, but the central figures in the saga, Najib and Low, have remained untouched. While many are calling for Najib to resign, more jaded observers note that his most outspoken critic, former Prime Minister Mahathir Mohamad, survived several corruption scandals during his own 22-year rule.

The Fund made some modest investments into Hong Kong during this period, so it was not immune to the down draft. However, its asset allocation, comprising a low weight in Hong Kong, a larger weight in Singapore, plus a

⁸ *Malaysia 1MDB Probe Says It Has Found Documents Tied to Alleged Transfers to Prime Minister Najib*, **Wall Street Journal**, 4 July 2015

⁹ *How Jho Low and PetroSaudi schemed to steal money from the people of Malaysia via 1MDB*, **The Edge Markets**, 20 July 2015

cash cushion, has been a good bulwark against the market swings in China. Your manager continues the search for investment ideas amid the changing tides of the stock market.

The next newsletter will be published for the quarter ended 30 September 2015.

Benjamin Koh
Investment Manager
Lighthouse Advisors
27 July 2015

3. Portfolio Review

As at 30 June 2015, the Net Asset Value (NAV) of the Fund was USD 100.99. Net of all fees, the year-to-date return was 1.1%.

19 securities made up 82% 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.

New Investments

CIMC Enric is a manufacturer of metal tank containers used for the storage and transport of natural gas (50% of sales), chemicals (30%) and liquid foods (20%). It is a subsidiary of state-owned enterprise China International Marine Containers.

The energy segment mainly serves the liquefied natural gas (LNG) market. Demand for LNG depends on the price spread against diesel, and the current low oil prices have reduced demand for LNG refueling station infrastructure, tanker trucks and conversion kits. Sales are expected to be flat for now.

The chemicals segment is considered to be mature, but the Group has a 60% market share world wide, which gives it important cost and thus profitability advantages over the second largest player, which has a 15-20% share.

The liquid food segment grew significantly after the acquisition of a German company, Ziemann. Ziemann has 160 years of history

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and was successful in the brewery equipment industry. It supplied China's first brewery plant under Tsingtao, in 1903. However, some poor management decisions, coupled with the global financial crisis, led to insolvency. The Group acquired Ziemann along with key employees, and has successfully parlayed it into new contracts, notably for Constellation Brands, where the "new" Ziemann was awarded a contract to expand the Piedra Negras plant in Mexico which had been built by the "old" Ziemann.

Historically, the Group has grown both organically and via acquisition. The moderate outlook is likely to drive acquisitions as owners become more willing to sell out. In the absence of major acquisitions, cash flow will be strong: the company's operations convert about 2/3 of reported profits into free cash.

The shares were acquired at 14 times earnings, at a yield of 2%.

Dongpeng Holdings is a Chinese manufacturer of bathroom ceramic tiles. Although Dongpeng is the largest player in China by retail sales value, its market share is less than 2%. The distribution network will be a key advantage in gaining market share. Currently, Dongpeng is present in over 600 cities, with nearly 2,000 retail stores. 74% of sales are to 968 tier-one distributors, with the balance sold directly to property developers, preferred dealers and consumers via self-operated retail outlets.

Although Dongpeng is indirectly exposed to the real estate market, there is a time lag as homeowners renovate their homes only after taking possession, so changes in the real estate market are moderated by the passage of time. 90% of sales are to first-time homeowners so Dongpeng's sales are tied to underlying urbanization trends, rather than demand for housing as an investment.

The shares were bought for 8 times earnings, with a 4% yield. In terms of EV/EBITDA, the multiple was 3.3x.

Divestments

CITIC Telecom was sold as the stock had appreciated substantially in recent months, despite the forward picture getting worse. The telecom hub business has not recovered as margins continue to erode and call volume is lost to VOIP providers such as Skype. Meanwhile, in Macau the decline in visitor numbers bodes poorly for CTM as roaming revenues are a significant contributor to profits. Gain on divestment was about 70%.

Sa Sa was sold due to a deterioration in the business environment. The "Occupy Central" protests in Hong Kong had already dented consumer confidence among Chinese shoppers, and the last straw came when the Chinese government stopped issuing multiple-entry visas to Shenzhen residents visiting Hong Kong. Instead, they could only once per week. Whether this was to punish Hong Kong for Occupy Central, or to appease Hong Kong by reducing Chinese shopper traffic, or both, the outcome was to eliminate the "day-tripper" customer commuting into Hong Kong for cosmetics, toiletries, and, yes, milk powder. Chinese clients form about half of Sa Sa's sales, so this was devastating. Lower sales and higher rents are a bad combination. Sa Sa was divested immediately after the visa restrictions were announced. Most of the shares were acquired via in-specie subscriptions when the Fund was launched. As a result, the cost base was high, and the loss on divestment was approximately 50%.

Other Significant Events

OUE proposed to sell its interest in One Raffles Place to OUE Commercial REIT for about S\$1 billion. This is at a small discount to the fair market value, so OUE will book a small loss of about \$0.02 per share on the disposal. The proceeds will be used for working capital. One Raffles Place was already flagged as a pipeline deal when OUE Commercial REIT was listed, so there were no surprises when it was announced. The deal has since been approved by shareholders.

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4. Stock Market Tycoon

In the classic computer game *Railroad Tycoon*, the player tries to amass a fortune by building and controlling a rail network. Besides operating the railways by laying track, building stations and buying trains, the player can also use the stock market to sell bonds for cash, or buy shares in their own corporation or that of rivals. Takeovers are possible, allowing the player to control rivals and raid their treasuries for cash. Wealth is maximized when the player makes shrewd decisions in both operations and finance.

Of course, *Railroad Tycoon* is at best a business simulation, but many real-life tycoons have accumulated great wealth with similar tactics. In business, tycoons are aggressive competitors fighting to protect their market share and maximize profits. In the stock market, they look to sell when assets are overpriced, and buy when they see a bargain.

Most businessmen will have neither the appetite nor the opportunity to take on a tycoon in business. But most investors will encounter a tycoon or two in the stock market at some point.

"Well, that's the news from Lake Wobegon, where all the women are strong, all the men are good looking, and all the children are above average."

- **Garrison Keillor**, *News from Lake Wobegon*

It is a well-known phenomenon of human psychology that most people think they are above average. But by definition, most people *are* average. True, sometimes the person in question is indeed above average, and then they may have an edge against the persons they interact with, who are, on average, merely average.

But tycoons are assuredly *not* average. Otherwise, they would have merely an "average" net worth. So what is one to do against such an "above average" opponent?

If one is an accomplished investor, one may very well choose to bet against the tycoon. For example, Carl Icahn has publicly clashed with William Ackman over **Herbalife**. Ackman has a short position against Herbalife, while Carl has a long position in Herbalife.

Who is right: Ackman or Icahn? While professional investors do (or are supposed to do) their own homework, many amateurs choose to follow the "smart money". But in this case there is smart money on *both* sides of the table. Both investors are billionaires who earned much of their fortunes in the stock market. On average, they have been right, but here they cannot both be correct. The simplest – and safest – answer in this case is to bet on neither side and watch from the sidelines.

More common, and far easier, are cases where there is a tycoon on only one side of the table. Almost always, the right thing to do is to decline the deal with the tycoon. Tycoons do deals to make money. That means they are trying to buy low and sell high. *If* the tycoon is right, those on the other side will be selling low and buying high. While tycoons do make mistakes, as a group, their accumulated wealth suggests that on balance they are correct.

A description of some notable tycoon deals in Asia follows.

In 2001, Quek Leng Chan's **Guoco Group** sold Dao Heng Bank to **DBS Bank**. DBS eventually paid S\$10 billion or about 3 times book value for Dao Heng. In 2005, DBS wrote off S\$1.1 billion against the investment, and in 2010 it wrote off another S\$1 billion. Total loss to DBS shareholders: S\$2.1 billion.

In April 2003, Ananda Krishnan privatized offshore vessel operator **Bumi Armada** for RM 7 per share, valuing the whole company at RM 441m. Bumi Armada reported earnings of RM 1.02 per share for 2002, so the shares were arguably cheap at about 7 times earnings.

Minority shareholders were essentially forced out: Krishnan had acquired a stake of over 70%, and if he was able to cause the free float

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to go below the 25% minimum for 6 months, the stock exchange would automatically delist the company. Minority shareholders risked being trapped in a private company if they did not sell to Krishnan.

In July 2011, **Bumi Armada** went public again in Malaysia. It raised RM 2.7 billion by selling 879m shares at RM 3.03 per share, valuing the company at RM 8.8 billion, or over 20 times 2010 earnings. The stock subsequently slumped when oil prices collapsed. Whether or not Krishnan foresaw it, the fact is that he bought low and sold high. On 30 June 2015 Bumi Armada shares closed at RM 1.14, marking the capital loss to the investing public at RM 1.67 billion.

In May 2007, Ananda Krishnan privatized telecommunications service provider **Maxis Communications**, paying RM 17.4 billion for the 53% stake he did not own, valuing the entire company at RM 33 billion. Maxis operated in Malaysia (100% owned), India (74%) and Indonesia (95%). In November 2009, **Maxis Berhad** re-listed in Malaysia, but this time it held only the Malaysian business. The company did not issue new shares. Instead, Krishnan sold 2.25 billion shares representing a 30% stake for RM 11 billion, valuing the company at RM 39 billion.

For a net cost of RM 6.4 billion, Ananda Krishnan had increased his effective ownership of the Malaysian business from 47% to 70%, and his effective ownership of the businesses in India and Indonesia from 35% and 45% respectively to 100% each. But that is not all. For 2007, 2008 and 2009, Krishnan had Maxis pay him dividends of RM 2.7 billion, RM 720m and RM 2.6 billion. He gave back RM 705m in the restructuring prior to the re-listing, so on a net basis he received RM 5.3 billion. Thus, the whole privatization-and-relisting exercise actually cost Krishnan only RM 1.1 billion.

In the 5-plus years since the IPO, the extra 23% of Maxis that Krishnan bought has paid

out RM 3.7 billion in dividends, so those shares have already covered their cost more than 3 times over. And Krishnan still owns the businesses in India and Indonesia. Maxis shares closed at RM 6.37 on 30 June 2015, valuing the entire company at RM 47 billion, and Krishnan's 70% stake at RM 33 billion.

In February 2011, Li Ka Shing's **Hutchison Ports** went public in Singapore, selling 3.8 billion units at US\$1.01 each. On 30 June 2015 it closed at US\$0.63 per share. Capital loss to the investing public: US\$1.44 billion.

In April 2011, Li Ka Shing's **Hui Xian REIT** went public in Hong Kong, selling 2 billion units at RMB 5.24 each. On 30 June 2015 it closed at RMB 3.48 per share. Capital loss to the investing public: RMB 3.52 billion.

In April 2014, Robert Kuok's **Pacific Offshore Services Holdings (POSH)** went public in Singapore, selling 338m shares at S\$1.15 each. On 30 June 2015 it closed at S\$0.435 per share. Capital loss to the investing public: S\$242m.

These deals were all perfectly legal, but clearly, the benefits were not equally distributed. In each case, the tycoon bought low, sold high, or did both. The investing public on the other side of the transaction did the opposite, and so by definition did not fare too well, to say the least.

Just because a deal is done on a "willing buyer, willing seller" basis does not mean that the benefits are shared equally. If one is dealing with a tycoon, the odds are high that the tycoon will receive the bulk of the value.

"Neither a borrower nor a lender be"

- **Polonius, Hamlet**

Perhaps the stock market equivalent with respect to tycoons is "neither a buyer nor a seller be".

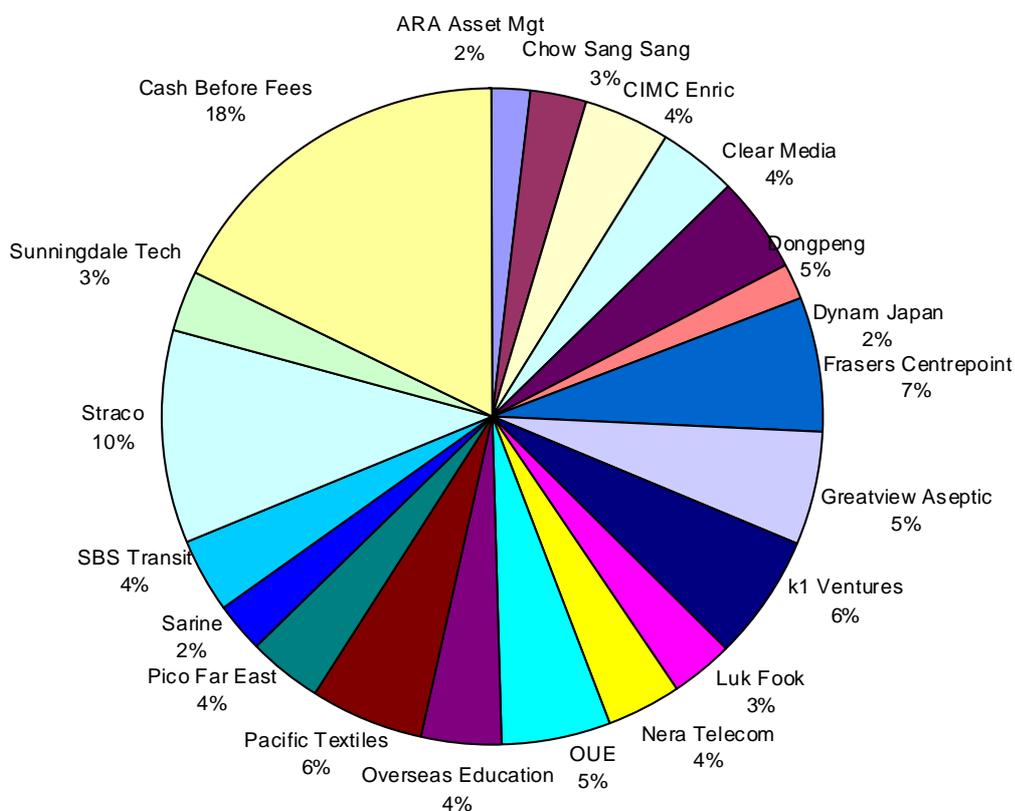
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Annex I

Fund Holdings as of 30 Jun 2015



Annex II

	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	YTD
2013								100.00	100.86	102.24	102.63	102.93	+2.9%
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							+1.1%