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Public Newsletter for the period ended 31 March 2017

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1. Foreword

Fellow Investors,

Welcome to the Lighthouse Advisors newsletter for March 2017.

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

2. Market Commentary

US president Donald Trump promised it would not be politics as usual. Unfortunately, such bravado has merely exposed his naïveté, as he has run headlong into the reality that politics is not business. In business, the CEO is effectively God within the company; his word is law. In politics, the president is bound by due process, with the result that Trump's travel bans and healthcare repeal have failed.

Trump's campaign declarations targeting Muslims have returned to haunt him as evidence that his travel bans are disguised anti-Muslim measures, while many of his party members abandoned "Trumpcare" when it became clear that millions of voters would lose insurance coverage[1], and would then kick the Republicans out at the next elections.

The proposed border tax measures have also created chaos. Two decades after the North American Free Trade Agreement was signed, many companies have supply chains that repeatedly cross the US-Canada and US-Mexico border. Once Trump is presented with hard evidence that the border tax will meaningfully raise prices to consumers, it would be political suicide to press ahead.

Very few finished goods are manufactured from scratch in the US – or indeed anywhere in the world. Trump previously boasted of engaging Apple to manufacture in the US. Great, except that Apple uses over 200 suppliers, most of whom are not in the US. A border tax of any sort would increase the price of Apple's products, and the blame would fall squarely on Trump.

Trump's latest admission that being President is "more work than in [his] previous life"[2] is the closest he has come to conceding he is out of his depth. It takes quite an ego to believe leading the world's most powerful country could be easier than running a business conglomerate, however large it might be.

Longer-term, the US will survive Donald Trump, but the short-term impacts will be felt for some time. Already, applications to American universities by students from the Middle East have fallen materially[3]. As these students are likely to form the next generation of immigrants, their decision to study elsewhere is America's loss. 40% of the US Fortune 500 companies, including AT&T, IBM, Coca-Cola, Microsoft, McDonald's, Goldman Sachs, eBay, Kohl's, Comcast, Pfizer and Yahoo, were founded by immigrants or their children[4]. Other "cool" companies like Amazon, Apple, Google and

[1] *American Health Care Act – Budget Reconciliation Recommendations*, **Congressional Budget Office Cost Estimate**, 13 March 2017.

[2] *Exclusive: Trump says he thought being president would be easier than his old life*, **Reuters**, 28 April 2017.

[3] *International Applicants for Fall 2017 – Institutional and Applicant Perceptions*, **Institute of International Education**, 13 March 2017.

[4] *The CEOs revolting against Trump's travel ban*, **The Atlantic**, 20 January 2017.

Tesla were also founded by immigrants or their children. If Trump wants to "make America great again" the logical thing to do would be to accept *more* immigrants, not less.

Europe continues to be mired in uncertainty. The first quarter was marked by continued squabbling in the UK Parliament over Brexit; that has been "resolved" with the triggering of Article 50 on 29 March. Now begins the long process of negotiations, in which the UK begins at a clear disadvantage, with Germany determined to demonstrate to other potential leavers that exiting the EU is a bad idea, and Spain also determined to prevent Scotland from getting an easy re-entry into the EU, lest it inspire its restive Catalonia region.

In China, the economy continues to function normally, but the slower growth has intensified competition everywhere, with many companies closing stores and plants in order to consolidate their operations. Declines in same-store-sales and net shrinkage in store networks are par for the course at present. State-owned enterprise reforms also continue apace, with the latest target being the power sector. China Shenhua, China's largest coal miner, and China Datang, one of China's largest power generation groups, have been prodded to merge to realize cost synergies[5].

Korea has not solved its headaches despite jailing its former president Park Geun-Hye. Economically, it now faces China's wrath over the proposed deployment of the Terminal High Altitude Area Defense (THAAD) system. THAAD is meant to help defend South Korea against a missile attack from North Korea, but China has deemed it a threat to its own security. Chinese travel packages to Korea have been cancelled, and Chinese cruises have swapped their Korean destinations for Japanese ones. Nearly 50% of Korea's foreign tourists in 2016 came from China, so the impact is significant.

Within China, Korean businesses have also been impacted. The Lotte Group, which sold the land for THAAD to the Korean government, has been hard-hit: of its 99 Lotte Mart stores in China, 67 have been suspended by the government, while 20 have voluntarily closed due to anti-Korea protests. Industry watchers estimate the closures will cost Lotte over US$100m a month in lost revenues[6]. This is just one more reminder to investors that they ignore politics at their own peril.

In Hong Kong, Carrie Lam has been chosen to be the next chief executive. Despite a glittering career in the civil service, Beijing's support for her means many now view her as a mere puppet. It will be an uphill battle for her to implement her policies, even if they are well-founded. Hong Kong residential property is famously unaffordable and remains a cause of deep-rooted unhappiness. It remains to be seen if Ms Lam can improve things. For now, the much-reduced number of Chinese tourists has hit retailers hard, and landlords are finally reducing street-level rents.

In the Singapore and Hong Kong stock markets, your manager's prediction of continued buyout activity holds true. The portfolio has already benefited from such actions, and nearly half the portfolio is invested in companies where deals are either active or very likely to occur. For the Fund, given the sheer number of such investments, 2017 will likely be "The Year of The Special Situation".

The Fund has received some subscriptions and welcomes more. Incremental money is currently being put to work at high expected rates of return. The outlook for investments this year is promising. The next newsletter will cover the quarter ended 30 June 2017.

Benjamin Koh
Investment Manager
Lighthouse Advisors
30 April 2017

[5] *China to Push Merger Talks to Form $231 Billion Energy Giant: Sources*, **Bloomberg News**, 29 March 2017.

[6] *Lotte's China biz in peril as THAAD spat deepens*, **Yonhap News Agency**, 20 March 2017.

3. Portfolio Review

As at 31 March 2017, the Net Asset Value (NAV) of the Fund was USD 101.1. Net of all fees, the total return for 2017 was +12.1%.

For reference, for the 3 months ended 31 March 2017, the changes in the Fund's key markets were:

Market	Index	Change
Singapore	STI	+10.2%
Hong Kong	HSI	+9.6%
Shanghai	SSE	+3.8%

23 securities made up 93% of the Fund's holdings, with the balance in cash. NAV values are tabled in Annex I.

To protect the interest of clients, detailed discussion is confined to the client-only version of this newsletter. Client newsletters are embargoed for one year, after which they are made available online.

4. Payables

Payables are sums that a company owes to creditors. These creditors may be employees, suppliers, landlords and so on. Every company will have some payables on its balance sheet. The ratio of trade payables to the cost of goods sold, or trade payable days, reflects how long a company is taking to pay its suppliers. This ratio is usually stable, though for companies in seasonal businesses the ratio will change during the year. Payables are usually considered by investors to be a secondary data point and seldom draw as much attention as sales, earnings or debt. However, unusual levels of payables can give useful information. Some examples are discussed below.

Sitoy is a Hong Kong-listed manufacturer of leather handbags. Among its key customers is American luxury brand **Coach**. For the 6 months ended 31 December 2015, sales and profits were slightly lower than the previous corresponding period, by 3% and 5% respectively. However, trade payables fell by 30% against the previous year.

An observant investor would have realized that something was amiss: either suppliers had suddenly gotten much stricter, or customer orders had dropped, causing orders to raw material suppliers to decline, in turn lowering trade payables. Indeed, half a year later, when results for the year ended 30 June 2016 were released, sales fell 30%. No profit warning was given because the reported profits for the full year fell by only 10%, but this was propped up by an accounting gain on a bargain purchase in the second half. Stripping out this accounting gain, the decline in second-half profit was almost 50%.

The same trend of declining payables was even more pronounced in the 30 June 2016 results. Payables fell 60% against the same period a year earlier. Subsequently, on 27 January 2017, Sitoy issued a profit warning that its 6-month profits for 31 December 2016 would "decrease substantially" compared to the previous period, due to "decrease in global demand from high-end and luxury brand customers in the manufacturing business".

Investors who waited for the official profit warning to sell were too late: two months earlier, on 18 November 2016, Sitoy's share price lost 17% in a single day. Between 17 November and 26 January, the stock lost over 30% of its value. A conservative investor taking note of the decline in trade payables could have sold out early, way back in February 2016. Waiting for the 30 June 2016 results to confirm that the declining payables foretold a sales decline would still have let the investor exit in September 2016, two months ahead of the price collapse.

So in this case, a decline in trade payables was an unannounced profit warning.

Tianneng Power is a Hong Kong-listed manufacturer of lead-acid batteries. This is a capital-intensive business with fierce price competition. High levels of debt are *de rigeur* for the industry. Tianneng reported in its 30 June 2015 interim results that its gearing ratio had improved, from 41% on 31 December 2014 to 29% on 30 June 2015.

Total bank borrowings fell from RMB 3.6bn to RMB 2.8bn. This was impressive, but an investor might wonder where it got the cash to pay down its debt when pretax profits were only RMB 338m.

The balance sheet shows that while Tianneng's bank borrowings fell by nearly RMB 800m, this was offset by a RMB 1.2bn *increase* in bills payable. Bills receivable increased by RMB 532m, so the net effect was that Tianneng "borrowed" RMB 665m from its suppliers by delaying payments via the use of bills payable.

As with many such actions, once you start, you cannot stop: Tianneng's bills payables have been elevated for the last 4 accounting periods through 31 December 2016. **Debt-averse investors should take into account bills payable when computing debt ratios.**

Investors should also note that trade payables can be offset by advance payments, which are recorded as assets in the balance sheet. The true level of trade payables should be computed by offsetting any advance payments against the reported trade payables.

Anta is a Hong Kong-listed company that manufactures and sells shoes and apparel under the *Anta* and *FILA* brand names. It is China's largest domestic footwear brand by sales. For 31 December 2016, Anta's trade payables were RMB 916m. Against the cost of goods of RMB 6.9bn, this was 49 payable days, close to the 46 days sales outstanding for trade receivables.

However, inside the RMB 1.7bn of "trade and other receivables" was RMB 523m of "advance payments to suppliers". In other words, Anta is financing its suppliers by making payments in advance of delivery. So Anta has to keep additional cash on hand because the "Bank of Anta" needs to lend money to suppliers.

When Anta's trade payables are adjusted by the advance payments, its adjusted payable days are only 21 days. In previous years it was even worse: during 2012-2015 Anta's adjusted payable days ranged from 10-13 days. For 2011, Anta's adjusted payables days were actually *negative* at -11 days.

What does this mean? It means that, despite Anta apparently being a strong local brand with great prospects, it is highly dependent on a network of suppliers who are financially weak. **Nike** and **Adidas** make no such payments to their suppliers. True, Nike and Adidas do not manufacture shoes in-house, so they are not strictly comparable. But **Yue Yuen**, the world's largest shoe manufacturer, and a key supplier to Nike and Adidas, reported US$80m of deposits paid to trade suppliers on 31 December 2016, against US$445m of trade and bills payables. Yue Yuen operates in China too, so it would face the same supply chain issues as Anta, but it has kept such advance payments to less than 20% of its trade payables.

Anta is not the only Chinese sports brand financing its suppliers. **361 Degrees**, a competitor listed in Hong Kong, also makes substantial prepayments to suppliers. In 2015 and 2016, such prepayments covered about 30% of the trade payables, while in 2013 and 2014 the prepayments offset about half of the trade payables. In 2011, 361's prepayments offset over 75% of its trade payables.

There is an old saying that "a chain is only as strong as its weakest link". **Risk-averse investors should consider a company's dependence on its suppliers.**

End

LIGHTHOUSE ADVISORS

Keeping Your Capital Safe

Annex I

	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										**+12.1%**

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.