LIGHTHOUSE ADVISORS
Keeping Your Capital Safe

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Public Newsletter for the period ended 30 June 2017

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1. Foreword

Fellow Investors,

Welcome to the Lighthouse Advisors newsletter for June 2017.

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

2. Market Commentary

The US economy continued its strength in the second quarter. Unemployment reached a 16-year low of 4.3% in May before inching up to 4.4% in June.

In contrast, US president Donald Trump has been dogged by controversy over Russian interference in the elections. Despite White House dismissal of investigations as a "big nothing burger", evidence potentially incriminating Trump's son Trump Jr. has surfaced[1]. Of course, even if Trump Jr. is guilty of a crime he may not be prosecuted; the rich and powerful have long had special privileges. Still, it will be interesting to see what is used to keep him out of jail. Trump Sr. hinted at one possibility when he announced out of the blue on Twitter that as President, he had unlimited powers to pardon anyone.

A "nothing burger" also describes Trump's policy achievements to date. Across the broad themes of healthcare, immigration, tax reform and infrastructure, Trump's proposals have either been soundly defeated or heavily watered down. As for trade, threats to cancel NAFTA have evaporated in the face of protests from manufacturers, while attempts to bully China on trade have gone nowhere.

One common-sense indicator of how bad Trump's ideas are: despite Republican control of both houses of Congress, no substantive bill featuring a Trump idea has been passed as proposed. In other words, Trump's plans are so obviously bad for America that even his own party members find themselves unable to support him. Some of the projected outcomes of Trump's plans: "Trumpcare" would cause 26 million Americans to lose insurance coverage, his tax reform would give *more* tax breaks to the ultra-rich like himself while increasing taxes on the middle class[2], and the Trump infrastructure plan would reduce funding for power lines and internet access[3].

Without Trump's ideas, America continues to function based on the work of his predecessor Barack Obama, which means that the **first** term of President Donald Trump is essentially the **third** term of Barack Obama. That is, by most empirical measures, not an entirely bad thing. So ironically, it is by Trump being a **policy failure** that America is continuing to enjoy **economic success**. Or, to use Trump's language, by doing nothing he is letting the rest of the country "make America great".

In Europe, the Brexit standoff continues. There is widespread consensus that a "soft" Brexit, wherein the UK leaves but keeps most of its access to the EU market intact, is all but impossible given the tight timelines. So a "hard" Brexit is looking inevitable, meaning that overnight, the UK will face significant

[1] *Donald Trump, Jr.,'s E-Mails Have Fundamentally Changed the Russia Story*, **The New Yorker**, 11 July 2017.

[2] *Report: 20 percent of Americans could pay higher taxes under Trump's plan*, **CNBC**, 28 July 2017.

[3] *With Trump's Infrastructure Plan, Rural Texas Could Be Left In Disrepair*, **Texas Observer**, 18 August 2017.

tariffs and outright caps on its exports to the EU. There is of course the option of "undoing" Brexit, which has been frequently hinted at by the EU side as a preferred option. But until and unless Teresa May is deposed, a new "Breturn" referendum is wishful thinking.

The cost of Brexit continues to accumulate. The latest tally is that 10,000 banking jobs and 20,000 other financial services roles will leave, along with €1.8 trillion in customer assets[4]. The biggest job moves come from JPMorgan (4,000), Deutsche Bank (4,000), UBS (1,500), Goldman Sachs (1,000) and HSBC (1,000). Frankfurt is the most popular destination, followed by Paris. The impact will be felt beyond the banks' offices: taxes paid by employees and the jobs supported by their consumption spending will all move offshore.

In China, the economy continues to adjust to slower growth. Some industries are finally matching supply and demand: cement producers have held back on capacity increases, sending prices soaring and returning the industry to profitability. Meanwhile, property investors have repurposed unsold high-rise apartments into serviced apartments, whereby the owner of several units (or even an entire floor) renovates them for short-term rentals and provides basic housekeeping services. This is Airbnb, China-style. Your manager stayed in such converted apartments during a visit to Chengdu and Chongqing. The Chongqing apartment was attached to a mall, located next to a monorail station and furnished to a five-star hotel standard, but cost less than RMB 200 per night. Traditional chains like *Hyatt* and *Hilton* have their work cut out for them, as even local chains like *7 Days Inn* and *Days Inn* are now using such "serviced apartments" to compete for guests.

The Middle East continues to surprise. In early June, Qatar's neighbours broke off diplomatic relations, citing its support for Islamic terrorism[5]. However, external observers have pointed to other reasons for the crisis, such as Qatar's independent foreign policy and its *Al-Jazeera* news network, which has sometimes been critical of Qatar's neighbours[6]. Indeed, reform of *Al-Jazeera* seems to be a key demand for lifting the blockade.[7]

What is one to make of all this chaos? To quote from William Shakespeare's *Macbeth*:

> *Life's but a walking shadow, a poor player*
> *That struts and frets his hour upon the stage*
> *And then is heard no more. It is a tale*
> *Told by an idiot, full of sound and fury,*
> *Signifying nothing.*

From Donald Trump to Theresa May, Xi Jinping and Kim Jong Un, everyone has their allocated time on the world stage, their one hour of fame (or 15 minutes, if one prefers Andy Warhol). After that, life goes on.

Special situation investments continue to occupy an outsized weighting in the Fund. Despite multiple conversion events, special situations still comprise over 30% of the Fund's current assets. So far, 2017 is indeed turning out to be a "special" year.

The Fund has received some subscriptions and continues to welcomes more. The high level of cash as of 30 June 2017 reflects these inflows; the Fund's current cash level is much lower. Despite the strong first half, the outlook for the second half still seems good. The next newsletter will cover the quarter ended 30 September 2017.

Benjamin Koh
Chief Investment Officer
Lighthouse Advisors
21 August 2017

[4] *Frankfurt Is the Big Winner in Battle for Brexit Bankers*, **Bloomberg News**, 26 July 2017.

[5] *Gulf plunged into diplomatic crisis as countries cut ties with Qatar*, **The Guardian**, 5 June 2017.

[6] *Why Saudi Arabia and six other countries have cut ties with Qatar*, **news.com.au**, 6 June 2017.

[7] *Qatar crisis: Can Al Jazeera survive?* **BBC News**, 8 June 2017.

3. Portfolio Review

As at 30 June 2017, the Net Asset Value (NAV) of the Fund was USD 107.1. Net of all fees, the year-to-date total return for 2017 was +18.8%.

For reference, for the 6 months ended 30 June 2017, the changes in the Fund's key markets were:

Market	Index	Change
Singapore	STI	+11.6%
Hong Kong	HSI	+16.7%
Shanghai	SSE	+2.9%

20 securities made up 85% 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. Customer Claims

Customer claims are something that every business deals with sooner or later. Whether it is goods or services, sooner or later an unhappy customer will demand compensation for something gone wrong. Compensation can range from a partial refund or a credit against future business to a complete replacement of defective products at the company's expense.

However, logic dictates that a supplier should not be liable for damages *beyond* the value of the goods and services provided. It is the responsibility of the *customer* not to use defective goods or accept inferior services, since that would cause problems to cascade onwards to its own customers. For example, if a real estate developer uses sub-standard cement, and its building suffers structural damage as a result, the buyers of the real estate would sue the developer. The developer would in turn sue the cement supplier, who might then sue the cement producer. Each party in the supply chain owes a duty only to its immediate customer.

Warranty work is costly for obvious reasons. It is thus basic common sense to ensure that the defect rate is low enough that the cost of warranty service can be absorbed by the company. In many businesses, the acceptable defect rate is no more than 5%, and often 1% or less is required to sustain profitability.

Therefore there are 2 simple rules with respect to customer claims: supplier liability should be limited to the value of goods and services provided, and defect rates must be kept low in the normal course of business.

However, such rules are sometimes broken, as we will see from two case studies. Spoiler: there is no happy ending.

Foreland Fabrictech is listed on the Singapore Exchange. It is a manufacturer of functional and normal fabrics, which are sold to apparel manufacturers and textile traders. Foreland went public in 2007, but traces its roots to 1988 when its key subsidiary Fulian Knitting ("Fulian") was founded by Tsoi Kin Chit. Its IPO prospectus claims that its competitive strengths include: research and development collaborations with technology partners, an experienced management team with over 10 years' experience, a strong reputation and credible track record, technically advanced production facilities, vertical integration, and the capability to manufacture fabrics to various standards.

However, in December 2013, the Company reported that a customer, Jiangxi Longdu, had claimed compensation from Fulian for defective textiles. For the RMB 4m order, a claim of *RMB 290m* was being made. The damages claimed were over **70 times** the value of the actual order, a ratio so preposterous it seems incredible that Jiangxi Longdu could reasonably believe it could claim such an amount. In a subsequent announcement, the Company provided a breakdown of the claim, wherein the value of the textiles supplied were only *13%* of the amount, with the balance

made up of foregone profits, costs incurred in using the textiles, marketing costs and claims against Jiangxi Longdu by its own customers.

At a board meeting in January 2014, the independent directors took the view that given the size of the claim, an audit firm and a law firm should be appointed to investigate, or that an extraordinary general meeting should be convened to seek shareholders' views and support. The consolidated balance sheet for 30 September 2013 showed that the entire Group held only RMB 293m of cash, so RMB 290m represented essentially all of the Group's cash. Paying out the claim in full would create a liquidity crisis for the Group, so the independent directors were sensible to urge a more thorough investigation.

Shortly after, 2 of the 3 independent directors quit, citing differences with the management over the dispute with Jiangxi Longdu. In May 2014, the Company announced that it was settling with Jiangxi Longdu for RMB 283m, comprising damages of RMB 275m and penalty interest of RMB 8m. This was done over the objections of the sole remaining independent director, Lim Siang Kai, who tendered his resignation the same day.

So despite the company's experienced management team, it was only the independent directors who exhibited any shred of common sense with respect to Jiangxi Longdu's enormous claim, and they resigned when they were not able to convince Mr Tsoi to convene a full investigation. This was despite the fact that Mr Tsoi owned 44% of the company and thus had the most to lose from any payment to Jiangxi Longdu.

Unsurprisingly, the shares cratered. When the claim was first announced, the shares traded at SGD 0.028. They fell to SGD 0.018 when it was disclosed that the claim would be paid nearly in full, a loss of over 35%.

In January 2015, the company appointed BDO to carry out an independent review of the Jiangxi Longdu claim, Fulian's cash balances, and the holding company's investments into and amounts due from a subsidiary. The review was completed in May 2016, and the full report was submitted to the Singapore Exchange, the Audit Committee and the Board of Directors, while the executive summary was released publicly.

The executive summary lists numerous management failures at Fulian. Among them: there was no independent verification that the supplied fabric was defective, no analysis was done on whether any part of the claim was accurate, true or reasonable, Jiangxi Longdu's customer was a shell company with no place to store the finished products, Fulian had no product liability insurance coverage, and Fulian's bank balances could not be confirmed by its bank. It ended with the understatement that Mr Tsoi "may have" breached his fiduciary duty to Foreland and Fulian.

What has Mr Tsoi been up to? On 18 June 2015, he sold 160.6m shares, a 29.5% stake, to a person named Huang Wen for SGD 1m. On 1 August 2016, he resigned from the board "to pursue other interest", and on 9 December 2016 he sold another 27m shares, bringing his stake below the 5% disclosure level. For all intents and purposes, he has vanished.

As for the shares, they have been suspended from trading since 23 December 2016. The last time they traded, on 14 December 2016, they changed hands at SGD 0.009. From the IPO at SGD 0.21, the loss has been over 95%.

Our second story also comes from the textile industry. **China Taisan Technology** went public on the Singapore Exchange in 2008. It produces "performance and normal fabrics" used in apparel manufacturing. Its IPO prospectus lists the following as competitive strengths: they are an approved supplier to reputable international and local brands, they have strong research and development capabilities from collaborations with various third party research institutes, they possess an established track record and reputation, they have an experienced management team, they use advanced equipment in their production

process, and they are able to manufacture fabrics to various standards.

Despite its “experienced management team” with “an established track record” of combining “strong research and development capabilities” and “advanced production equipment” to “manufacture fabrics to various standards”, China Taisan also stumbled.

In November 2014, the company disclosed that 5 customers had encountered “quality issues” with the company’s products from March 2014 to September 2014. In January 2015, it revealed that fabric sales to these customers totaled 6,270 out of a total of 6,573 tonnes delivered in all of 2014. The company would replace the defective fabric on a 1-for-1 basis.

Another announcement in April 2015 restated the defective fabric volume to be 6,640 tonnes. In September 2015, the Company further disclosed that the defective fabric had *not* been collected back, but had been sold for scrap directly from its customers’ warehouses. It stated that the Audit Committee had visited the Group’s factory in China to interview the key management involved, and had followed the Auditors when the Auditors went to interview 4 major affected customers as part of their audit field work.

The 2014 annual report reveals some interesting data. Note 29 states that no customer accounted for more than 10% of sales in 2013 and 2014, while Note 33 states that the defective products were sold for RMB 605m in 2014. Fabric sales in 2014 were RMB 772m. Taken together with the previous announcements about the claims, this implies that in 2014, over 78% of sales by value, and over 95% of sales by tonnage, consisted of defective products! This constitutes a total failure in the manufacturing process, an extremely unlikely situation given the experienced management team. Furthermore, since no customer accounted for more than 10% of sales, it was mathematically impossible for just 5 of them to collectively account for 78% of sales.

Faithful shareholders who stuck it out have been punished. For 2016, which was over a year after the defective product incident, fabric sales were just RMB 108m, a decline of over 85% versus 2014. The company has shifted its focus to fabric processing on account of better margins; processing fees were RMB 100m in 2016, against just RMB 26m in 2014. After asset impairments, the company reported a loss of RMB 139m in 2016.

What did the owner-managers do? It was abruptly revealed in June 2016 that back in 2010, the Chairman and CEO had pledged their shares in the company to a margin lender as collateral for non-recourse loans for their personal investments. The Chairman Mr Choi Cheung Kong pledged 15% of his 34% stake, while the CEO Mr Lin Wen Chang pledged his entire 9.4% stake. By May 2011, both blocks of shares had been sold off, leaving Mr Choi with a 19% stake and Mr Lin with no ownership interest at all.

As the loans were non-recourse, they were effectively a sale of the shares at a discount. In other words, 2 years after going public, during a year in which the company reported a 63% growth in sales and a 136% rise in profits, both founders saw fit to sell off large chunks of their holdings at a discount. This was hardly a vote of confidence.

I find your lack of faith disturbing.

\- Darth Vader, **Star Wars Episode IV**

Like the hapless Admiral Motti caught in Darth Vader’s Force-choke, the share price of China Taisan has been crushed: the shares went public in June 2008 at SGD 0.24, but at the time of writing they last traded at SGD 0.045 *after* a 20-to-1 share consolidation, a 99% loss in market value.

Now come the lessons: could investors have reduced or avoided the losses that ultimately befell Foreland and China Taisan? **Yes. They had at least three chances.**

Firstly, at the IPO itself. Reading the IPO prospectuses of both companies, one could deduce that neither company had any real competitive strength. In a mature industry like textiles, an experienced management team, advanced machinery and the capability to manufacture products to required standards are not competitive strengths, but basic requirements. All the losses could have been avoided by not investing in the first place.

Secondly, a few years after IPO. In the years prior to their meltdown, despite being comparatively small companies, both Foreland and China Taisan reported operating margins far above their much larger peers, who were listed in Hong Kong. The following table shows the disparity.

	FY2006-FY2010	
Company	**Average Operating Margin**	**Total Sales USD mn**
Foreland Fabrictech	25.3%	259.4
China Taisan	26.7%	640.2
Pacific Textiles	13.4%	2,890.0
Victory City	9.6%	2,416.0
Texhong Textile	10.1%	2,763.3

Pacific Textiles, Victory City and Texhong Textile each reported total sales of USD 2.4-2.9bn during FY2006-FY2010. Their sales were 4 times those of China Taisan and 10 times those of Foreland; they would clearly enjoy significant economies of scale. Yet, their operating margins were clustered in the 10-13% range. In a mature industry, larger players enjoy economies of scale in procurement, manufacturing and sales, potentially giving them slightly higher margins than smaller ones. The results of Foreland and China Taisan were inconsistent with this logic. During 2011, investors had a chance to exit when such data became available. Foreland's shares repeatedly traded around SGD 0.14 in 2011 after the 2010 results were reported. Counting from the IPO, losses would have been limited to 33% for investors who exited at this point. For China Taisan, the shares traded as high as SGD 3.50 (split-adjusted) after the 2010 results announcement, and an exit at this level would have limited losses from the IPO price to 27%.

Finally, when the product defects were announced. For Foreland, the shares traded at SGD 0.028 when the fabric problems were announced. They ultimately fell to SGD 0.009 before trading was suspended. A further 68% loss in market value could have been avoided by selling as soon as the claim was announced. In the case of China Taisan, after the first product defect announcement, the shares traded at SGD 0.78 on a split-adjusted basis, selling immediately instead of holding on until SGD 0.045 would have allowed investors to avoid 94% of the future losses. Even if investors had waited until the second announcement which revealed that 95% of the products by tonnage were defective, they could have sold within the next month at prices above SGD 0.60, limiting the loss to some 23% of their capital.

To conclude, investors are seldom completely deprived of information. There is useful information everywhere. One merely has to look for it, whether in the IPO prospectus, in a peer comparison, or in the company's recent announcements. **For customer claims, alarm bells should ring when claims far exceed the contract value, or when reported defect rates are very high.** In the case of Foreland and China Taisan, although IPO investors had already suffered large losses by the time the outsize claims arose, exiting quickly when the claims were first announced would have still allowed them to avoid further heavy losses.

~ End ~

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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	101.39	105.74	107.11							**+18.8%**

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.