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Public Newsletter for the period ended 30 Sep 2019

1. Foreword

Fellow Investors,

Welcome to the Lighthouse Advisors newsletter for September 2019.

This newsletter follows the same format as previous issues. The special topic for this issue is **Old Wine, New Bottles**.

2. Market Commentary

Global economic growth remains shaky. There is little good news as the US-China trade war is ongoing, Europe remains consumed by Brexit issues while Hong Kong's protests seem to have no end in sight.

US tariffs on Chinese goods increased on Sep 1, with another round due on Dec 1. While US president Donald Trump has insisted that "China's paying for those tariffs", independent analysis shows that in 2018, 100% of the tariffs were born by American consumers[1]. The outcome in 2019 is unlikely to be any different.

In Europe, although the second quarter saw "the end of May" in both calendar- and UK prime minister-terms, Brexit continues to torment the UK, as its "prime minister for now" Boris Johnson was forced to ask the EU for yet another extension after failing to get approval for a Brexit deal in time. The deadline has been extended to 31 Jan 2020, and Johnson is pushing for a general election in December[2].

The disruptions in Hong Kong reached new highs (or lows) in mid-November. Radical protesters barricaded themselves in university campuses[3], while police deployed specialized anti-riot vehicles and equipped officers with assault rifles and submachine guns[4]. However, the just-concluded district council elections showed overwhelming public support for the pro-democracy candidates[5]. It remains to be seen whether the voting results will change how the Hong Kong government deals with the protests.

Unsurprisingly, since June, Hong Kong's retailing industry has been hit hard, both by direct vandalism[6] and from lost sales[7]. Stock prices have dropped accordingly, and your manager has waded into the market to pick up some "fallen angels". It is too early to say whether this is brave or foolhardy, but buying strong businesses near liquidation value should eventually work out well.

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[1] *The Impact of the 2018 Trade War on US Prices and Welfare,* **National Bureau of Economic Research**, March 2019.

[2] *Brexit: Johnson agrees to Brexit extension - but urges election,* **BBC**, 28 October 2019.

[3] *Hong Kong protests: bitter stand-off inside Polytechnic University continues with as many as 100 activists still on campus, determined to evade capture,* **South China Morning Post**, 20 November 2019.

[4] *Police respond to more menacing mob attacks by bringing out lethal anti-riot weapons not used earlier in unrest,* **South China Morning Post**, 20 November 2019.

[5] *Hong Kong elections: pro-democracy camp wins 17 out of 18 districts while city leader says she will reflect on the result,* **South China Morning Post**, 25 November 2019.

[6] *Hong Kong businesses affected by vandalism and arson during protests seen filing up to HK$600 million in insurance claims,* **South China Morning Post**, 28 October 2019.

[7] *Chanel, Rimowa delay new stores, Prada moving out, sales plummet at Moncler, Gucci – will Hong Kong become city of 'ghost malls'?,* **South China Morning Post**, 20 November 2019.

Updated 26 November 2019

The next newsletter will cover the quarter and year ended 31 December 2019.

Benjamin Koh
Chief Investment Officer
Lighthouse Advisors
26 November 2019

3. Portfolio Review

As at 30 September 2019, the Net Asset Value (NAV) of the Fund was USD 76.52. Net of all fees, the year-to-date return was -11.7%.

For reference, below are the changes in the Fund's key markets:

Market (Index)	1Q19	2Q19	3Q19	YTD
Singapore (STI)	+4.7%	+3.4%	-6.1%	+1.7%
Hong Kong (HSI)	+12.4%	-1.8%	-8.6%	+1.0%
Shanghai (SSE)	+23.9%	-3.6%	-2.5%	+16.5%
Fund	**+3.9%**	**-6.5%**	**-9.1%**	**-11.7%**

The poor results of the past 21 months have forced a fundamental rethink. Many cheap stocks have turned out to also be weak businesses, and their market prices have tracked deteriorations in operating results, reflecting the impaired fundamentals - and your manager's poor judgment.

Going forward, the portfolio is being restructured into a "barbell" where a stronger emphasis will be placed on business quality: either the business is very safe, and generates a modest above-inflation return, or the business does in fact have a strong market position, and generates an above-market return.

As the priority will be on quality over price, valuations of the fund's future holdings are expected to be somewhat higher. However your manager expects the new portfolio to weather market turmoil better, yet still benefit from organic growth or market disruption. Special situations will still feature in the portfolio as and when they are available.

21 securities made up 81% 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. Old Wine, New Bottles

Every business wants to present itself as doing something different. This is normal marketing, and as long as stakeholders – customers, suppliers, shareholders et al – understand this, there is no problem. But when stakeholders are misled (or fool themselves) that they indeed have something new, problems arise.

The We Company ("We", formerly known as **WeWork**) may be the most glaring example in recent history. At its core, We is/was simply a real estate sub-leasing business: sign a lease for a large space at $X per square foot, renovate it, sub-lease it to smaller tenants at $(X+Y) per square foot, repeat.

Somehow, We's founder **Adam Neumann** was able to market his real estate business as a new thing. At least some of his investors' gullibility can be traced to his personal charisma. But more (perhaps much more) of it can be traced to greed-induced blindness. The biggest investor was **Softbank**, and its CEO **Masayoshi Son** was likely searching for his next big hit after **Alibaba** (by far his most successful investment). Investors in Softbank's **Vision Fund** no doubt expected him to strike gold again.

But long before Softbank was forced to write down its investment in We from a valuation of US$47bn down to just US$7.8bn, many non-investors had already observed that We was using the same basic business model as **IWG** and **ServCorp**.

Both IWG and ServCorp are publicly listed, IWG in London and ServCorp in Australia.

True, neither is seen as sexy, hip or engaged with millennials, but more importantly they operate with the same real estate sub-leasing business model. ServCorp was founded in 1978, IWG in 1989 (as Regus). They are therefore obvious valuation proxies for We.

Some of We's key fundraising milestones:

Series	Date	Money Raised	Post-Money Value
A	Apr 2009	US$17.5m	US$97.0m
B	Nov 2010	US$41.0m	US$440.0m
C	Jul 2011	US$156.4m	US$4.8bn
D	Dec 2014	US$198.8m	US$5.0bn
E	Jun 2015	US$742.5m	US$10.2bn
F	Jul 2015	US$750.0m	US$15.8bn
G	Aug 2017	US$300.0m	US$21.1bn
Not stated	Nov 2018	US$3.0bn	US$45.0bn

The post-money value rose **464 times in 9 years**. There were multiple large jumps in value:

Date	Time since last funding	Change in Value
Nov 2010	19 months	4.5x
Jul 2011	8 months	10.9x
Jun 2015	6 months	2.0x
Jul 2015	1 month	1.5x
Nov 2018	15 months	2.1x

Even for a company that is doing extremely well (which We was not) these rapid upgrades would be startling. We is a private company, but forecasts used for its Series D funding were leaked online. Extracts are shown below.

Year	Est. Sales	Est. Op. Income	Est. Op. Margin
2014	US$74.6m	US$4.2m	5.6%
2015	US$260.3m	US$49.6m	19.1%
2016	US$714.7m	US$207.5m	29.0%
2017	US$1,549.7m	US$487.1m	31.4%
2018	US$2,860.3m	US$941.6m	32.9%

At US$5.0bn in Dec 2014, the company was being valued at 25 times its 2016 operating earnings, 2 years out, assuming a 10-fold jump in sales. This was an aggressive valuation on heroic growth assumptions. Since IWG and ServCorp are both listed, as a first cut it would make sense to use them for a reality check.

	Sales	Op. Income	Op. Margin	Mature Op. Margin
IWG				
2010	£1,040.4m	£8.1m	0.8%	6.5%
2011	£1,162.6m	£50.6m	4.4%	10.3%
2012	£1,244.1m	£90.2m	7.3%	15.2%
2013	£1,533.5m	£90.8m	5.9%	16.7%
2014	£1,676.1m	£104.3m	6.2%	
ServCorp	**Sales**	**Pretax Profit**	**Pretax Margin**	
FY2010	A$168.8m	A$2.9m	1.7%	
FY2011	A$182.1m	A$3.0m	1.6%	
FY2012	A$200.8m	A$18.3m	9.1%	
FY2013	A$208.0m	A$27.6m	13.3%	
FY2014	A$242.2m	A$34.2m	14.1%	

IWG (then known as Regus) disclosed the operating margins of its "mature" centres (defined as those open for over 1 year). These should set the upper limit for estimated operating margins at We. Likewise for ServCorp, pretax margins up to FY2014 peaked at 14.1%.

Both IWG and ServCorp managed to grow sales about 50% over 4 years, respectable but a far cry from We's projections: its *lowest* projected annual growth rate was 85%, when the *highest* that IWG and ServCorp actually managed were 23% and 16% respectively. So at a glance it is obvious that We's projected growth rates and operating margins for 2015-2018 were far too optimistic. Until the latest restructuring (see later), it is doubtful if Softbank had ever audited We's operations, whether before, during or after it invested.

In May 2017, an article in the online journal *Quartz* noted that the shared workspaces made trendy by We had already fallen out of favour, and that **90% of We's rented space was in fact private offices**. So instead of communal workspaces being the next big thing, tenants had reverted to conventional spaces. Since We was now behaving like IWG and ServCorp, it should have been valued on the same basis during the fundraisings in 2017 and 2018. Instead, its value was increased *9 times* over the Dec 2014 funding. So **an already aggressive valuation based on unrealistic expectations became an impossible dream**.

Those investing in 2017 and 2018 were almost guaranteed to lose money.

No dream lasts forever. The We bubble burst in September this year when the IPO failed and We ran short of cash. Softbank is going to invest yet more money into We, this time at a much lower valuation, in order to take control and save it. At US$7.8bn, We is now valued at less than the US$8.4bn in debt and equity funding it had raised up to the IPO filing. Unfortunately for Softbank, the US$47bn figure is still out there: it is also the value of We's committed leases over the next 15 years.

Of course, not everyone lost money on We. **Adam Neumann is a big winner**: as part of We's bailout by Softbank, he will sell US$1bn of stock to Softbank for cash and receive a US$185m consulting fee. The *Wall Street Journal* also reported in July that he had already cashed out US$700m from selling stock and borrowing against his remaining holdings. In the end, he may have pulled off the most successful legal con-job in modern finance. Surely he and We will become a case study and cautionary tale for venture capital and private equity investors – and an inspiration for a new generation of scammers.

End

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	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				**-11.7%**

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.