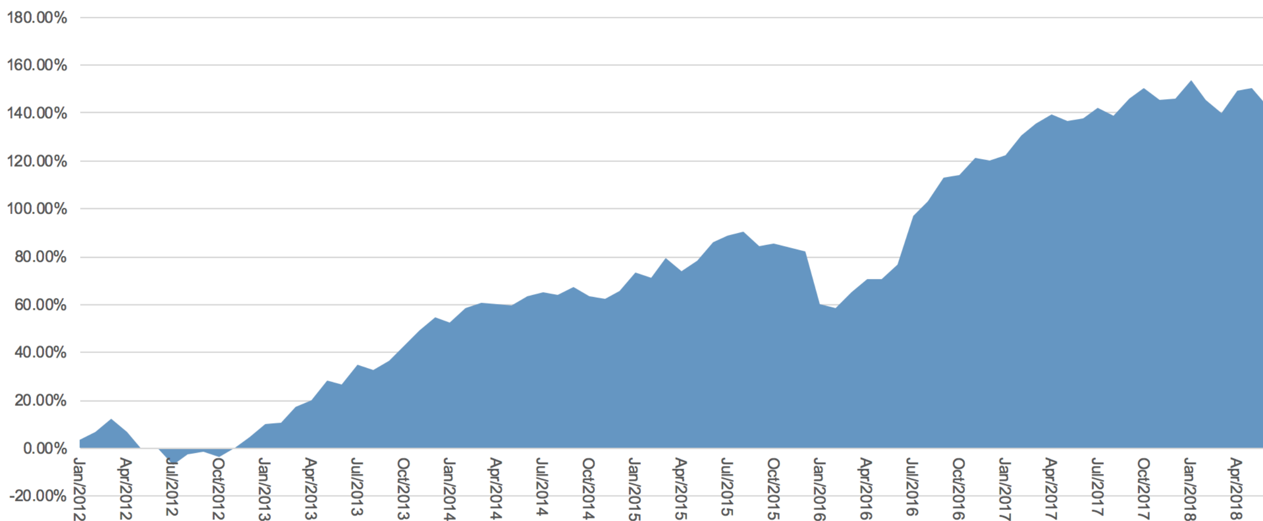
2018 Mid-Year Outlook



Year	Heritage Global Capital Fund	MSCI World Index (SGD, Dividends Reinvested)
2012	+4.58%	+9.74%
2013	+47.98%	+31.57%
2014	+7.09%	+10.68%
2015	+9.91%	+6.63%
2016	+20.73%	+10.37%
2017	+11.80%	+13.64%
2018 (YTD)	**-1.32%**	**+2.72%**
Cumulative	**+142.63%**	**+120.58%**
Annualised	**+14.61%**	**+12.94%**

For the six months ending June 2018, Heritage Global Capital Fund has returned -1.32% in SGD terms. Our benchmark, the MSCI World Index (Rebased to SGD with dividends reinvested) returned 2.72%.

Since January 2012, the fund's investment strategy has generated a cumulative return of 142.63% and an annualised return of 14.61% net of fees. This compares with the MSCI World Index (rebased in SGD terms) which has returned a cumulative return of 120.58% and an annualised return of 12.94%.

Market Review

While the US-North Korea summit may have ended on a positive note, fears of a damaging trade war between the US and its key trading allies persists.

Although these are still early days, signs of real damage have begun to surface with announcements of postponed or redirected investments.

Some markers that we see of how the trade war is beginning to have a negative impact:

- Due to Trump's administration's trade war with Europe, Harley-Davidson announced that it would move some manufacturing out of the US to avoid EU tariffs.
- Other car manufacturers such as Porsche and General Motors have too announced potential switches of production because of tariffs.
- Fed Chair Jerome Powell recently highlighted that, for the first time in this cycle, decisions to postpone investment are being mentioned by business owners, along with postponement of hiring.
- The escalation in trade skirmishes, combined with soft global growth momentum (outside of US) and US plan on interest rates hike could add to further woes on emerging markets, as evidenced by recent price actions.

That said, we would like to reiterate what we wrote in February 2018, which was the first major sell-off since the fund's inception.

Since 2011, we have had the personal experience of witnessing several events that we think warrant mentioning:

- *The first ever downgrade in the history of the United States of America of its credit rating from AAA to AA+ by Standard & Poors in August of 2011.*
- *Meltdown of Singapore listed Asiasions Capital, Blumont Group and LionGold Corp which lost S$8 billion in just three days of trading in October 2013.*
- *The inflation of the Chinese stock market bubble, and its subsequent crash. More than 30% of the value of the A-Shares listed on the Shanghai Stock Exchange was lost in less than one month in July 2015.*
- *The stock market rout during the month of January 2016. The Hang Seng Index fell over 35% to 18,319 in February 2016 from the high of 28,442 set in April 2015.*
- *The Shanghai Stock Exchange also fell close to 25%, from 3,539.18 to 2,655.66 in the month of January 2016.*

These events have coloured our investment philosophy. While we are not immune to market fluctuations, we have come back each time by the judicious avoidance of leverage, and the careful selection of investments in our portfolio.

Property Development & Cooling Measures

On July 6, 2018, the Singapore government implemented further cooling measures to rein in the property market. Prices of property developers fell promptly the next day in reaction to the news.

We had divested the majority of our pure play property developers such as City Developments and OUE as stated in our last year-end review in 2017. The prices had run up significantly since purchase reflecting the new underlying fundamentals of the property market.

We still own several construction companies with a certain amount of exposure the development sector via their own developments or from construction projects. These companies have the added advantage of having replenished their construction order book over the last 2 years.

Lian Beng for example, has an order book of almost a billion dollars as of the last financial quarter. The valuations of these construction/property developers are extremely compelling – and are close to their lows of 2016. Their fundamentals have dramatically improved with better earnings visibility from their core business of construction.

Lian Beng in particular was also fortuitous enough to list their property development arm before the cooling measures. They partnered with Oxley early on in the en-bloc cycle to snag both Rio Casa and Serangoon Ville. As a result, they have a cost advantage compared to other late stage buyers of en-bloc deals. Notably, they only own 20% of the projects and are insulated from being overly exposed to one project.

What Are The Government's Intentions?

Although the market has reacted negatively to the new cooling measures – we hold a different view.

Despite a small tweaking of the property cooling measures in 2017, the market has roared to life. News of en-bloc dominates the headlines and it really does seem that the entire Singapore is up for en-bloc.

Understandably, the government would be concerned with the recent state of developments. Although the world economy is still on the upturn, dark clouds are on the horizon. Furthermore, interest rates are on the uptick. Borrowing costs for mortgages have increased significantly for the first time in years.

Given this backdrop, it is prudent for the government to step in as property prices diverge significantly from the underlying economic growth of the country. Investors will no longer be able to benefit from a significant reduction in borrowing costs they did in the last crisis.

All cycles have the same underlying characteristic – the bigger the boom, the bigger the subsequent bust. The Singapore government has become far more pro-active in each successive property cycle to try to temper out the boom and subsequent bust that follows.

If the property market does plunge back into prolonged dolrums that is severe enough to impact the underlying economy of Singapore, you can be sure that policy makers will move promptly to reverse the cooling measures.

In short, what policymakers want is simple. They want a market that is simply lukewarm – neither too hot nor too cold. Secondly, there is a growing consensus (especially if one looks towards Hong Kong) that property is not meant to be an investment to speculate with, but to stay in.

The 2011 election reflects the serious political implications if the government fails to handle this properly and it is a scenario they are keen to avoid.

Why Are We Still Bullish On Construction Companies?

Understanding that government's intention, it is clear that the vast majority of property developers will emerge unscathed (although their projected profits will no doubt take a hit). The government's ultimate goal is a stable property market, and a self-induced goal via the collapse of multiple property developers and a depressed property market will do it no favours.

A significant amount of property development projects either from Government Land Sales or En-Bloc deals will continue and there will be significant work for construction companies in the coming years. On the other side of equation – government spending is also on track despite the hiccups with the High Speed Rail.

Investing In Property Has Changed

One of the biggest takeaways from the last decade is that the returns reaped from investing in the early days of Singapore's development are over. Economic growth will invariably slow as our population ages and we reached the status of a matured economy. It will be an achievement in itself if we can maintain a 3% growth rate). Property price growth will also reflect that.

Singapore and Hong Kong both face the same problem – the presence of excess liquidity and the abundance of savings chasing the same few investments – or in this case residential property.

Yields are perpetually low and the presence of cooling measures significantly reduce potential capital gains. Global capital flows and the presence of the elephant in the room – China, has forced the government's hand in coming up with cooling measures to reduce property investment for the simple reason that they need to be re-elected. Runaway property prices will win them no favours at the polls.

As such, while investors may still find residential property a reasonable store of wealth, we find it a far less attractive asset class than it was decades ago. Rents are unlikely to increase dramatically over the long run with the government keeping a watchful eye on property supply to ensure the market is well supplied.

Review of Divestments

China National Offshore Oil Corporation (CNOOC)

During the middle of December 2017, Brent oil prices touched a high of $65. Energy generally proves to be late market and economic cycle out-performer. We researched potential investment candidates in the upstream segment of the oil & gas industry. China National Offshore Oil Corporation, or CNOOC was one that fit our criteria of both having a strong balance sheet as well as attractive valuations.

Oil prices had rallied hard as OPEC and non-OPEC producers led by Russia agreed to extend oil output cuts until the end of 2018 in an effort to stabilise oil prices. Furthermore, potential supply disruptions once again appeared.

In Iraq there was a major risk to oil exports because of tensions with Baghdad. In Libya, militias were still fighting. In Nigeria the risks of disruptions were significant. Venezuela was on the verge of default. Iran looked to be locked out of the markets from US sanctions. Even in Saudi Arabia, political risk was on the rise.

CNOOC had significant exposure to the upstream exploration and production business. Furthermore, its oil reserve potentials were not accounted for in its balance sheet. In recent years, it had also placed an emphasis on cost control and strengthening its balance sheet. We felt that given its valuation, it offered an attractive risk/reward in the scenario that oil prices rose significantly.

We acquired our position CNOOC at an average price of HK$10.66 in December 2017. These shares were sold at an average price of HK$12.72 in April 2018, realising for the fund a gain of **+19.3%.**

Lee Metal Holdings

We held a view that the Singapore property market was recovering. Unfortunately, the developers were generally fairly priced and offered little upside. We went down the value chain to look at companies that would benefit from increased construction activity.

Lee Metal was one company that the fund invested in.

Lee Metal is an established distributor and fabricator of steel products as well a recognised international trader of steel and steel related products in the region. They have been in the industry for over 35 years and had carved out a solid reputation in the niche steel market.

Some of the products that they provide to the construction sector, including HDB and SMRT projects, are as shown below.

When we first initiated a position in Lee Metal, it was trading at 0.81x BV. The company was in a net-cash position. It sat on a cash hoard of approximately 42% of its market capitalisation.

The multiple property development projects as well as increased infrastructure spending would translate into an increase demand for many of Lee Metal's product.

In 2018, BRC Asia made an offer to buy Lee Metal Group at an offer price of 42 cents due to the potential synergies from the acquisition. Given that the offer price was deemed fair to us, we accepted the offer and sold our shares.

We acquired our position Lee Metal at an average price of SGD $0.312 in October 2017. These shares were sold at an average price of SGD $0.42 in June 2018, realising for the fund a gain including dividends of **+37.8%.**

Prospective Areas of Opportunity

The businesses we own are in strong financial positions and proven generators of both significant profits and free cash flow even during periods of distress. Therefore, given current market conditions, we have become net-buyers of select positions at current prices.

Within our portfolio, our luxury watches investment thesis has played out well, resulting in 2 of our core holdings to revaluing up sharply – Emperor Watch & Entertainment and Oriental Watch Holdings.

Luxury Watch Thesis

Very often, luxury watches are seen as a form of investment. However, let's take this one step further. Instead of buying these watches at face value (1x book value), would it not make greater sense to purchase listed luxury watch retailers that not only hold such luxury watches at cost on their books but also trade at a discount to their book values?

Brief History of the sector. Prior to 2012, walking down the streets of Hong Kong, one would notice luxury retailers such as Chow Tai Fook located near one another – on your left, probably on your right across the street, and if you turn around the corner, you would notice another Chow Tai Fook store.

Despite the number of stores in close proximity, one would find them packed with rich Chinese tourists.

The huge demand for such luxury goods led these luxury jewellery and watch retailers to expand aggressively. They rented more retail space to cater for the ever-increasing demand. Unfortunately, the lack of retail space led to severe demand/supply imbalance – and rental rates skyrocketed.

Dark clouds were on the horizon. In 2012, Chinese President Xi Jinping started his now infamous campaign to clamp down on corruption. Initial hopes that it would be short lived were dashed. Demand for such luxury goods fell dramatically as he went after both "tigers and flies". Luxury products like watches and alcoholic spirits were shunned as the practice of expensive gift giving was shunned.

Unfortunately, luxury retailers who had ambitious expansion plans found themselves locked into long-term rental contracts as demand plummeted. They were left with numerous outlets that were devoid of shoppers. Declining revenues and high rental costs cut into margins. Some luxury retailers even went into the red as demand failed to recover.

Fast Forward Today. In early 2017, we noticed the turnaround in Hong Kong's luxury watch retailers It is is dominated by a few players such as Emperor watch & Jewellery, Oriental Watch Holdings and Hengdeli Holdings.

The downturn in the luxury sector was so great that many outlets did not even bother renegotiating their contracts – they simple packed up and left. Landlords suddenly found that they could not command further increases in rent. Rental rates subsequently declined as a result.

Furthermore, we noted that a new class of consumers had emerged – the Chinese middle-income population. Income growth had finally led to a new class of consumers with new expectations and demands. This was evident from sales figures filtering in from international brands such as Coach, Swatch Group and LVMH. The luxury sector had finally begun to recover.

A company's bottom line is dependent largely on two factors – revenue and costs (expenses). A virtuous cycle had begun whereby revenues were increasing and rental rates were declining. The result was an improving bottom line from luxury retailers. Emperor Watch, one of our core holdings saw its losses narrow dramatically before finally turning the corner.

Today valuations of Emperor Watch & Jewellery and Oriental Watch Holdings have largely risen to reflect the new state of affairs. They have begun to move back into the black after a difficult few years. We still believe that there is still room to run for these holdings.

Company Highlight: Hengdeli Holdings

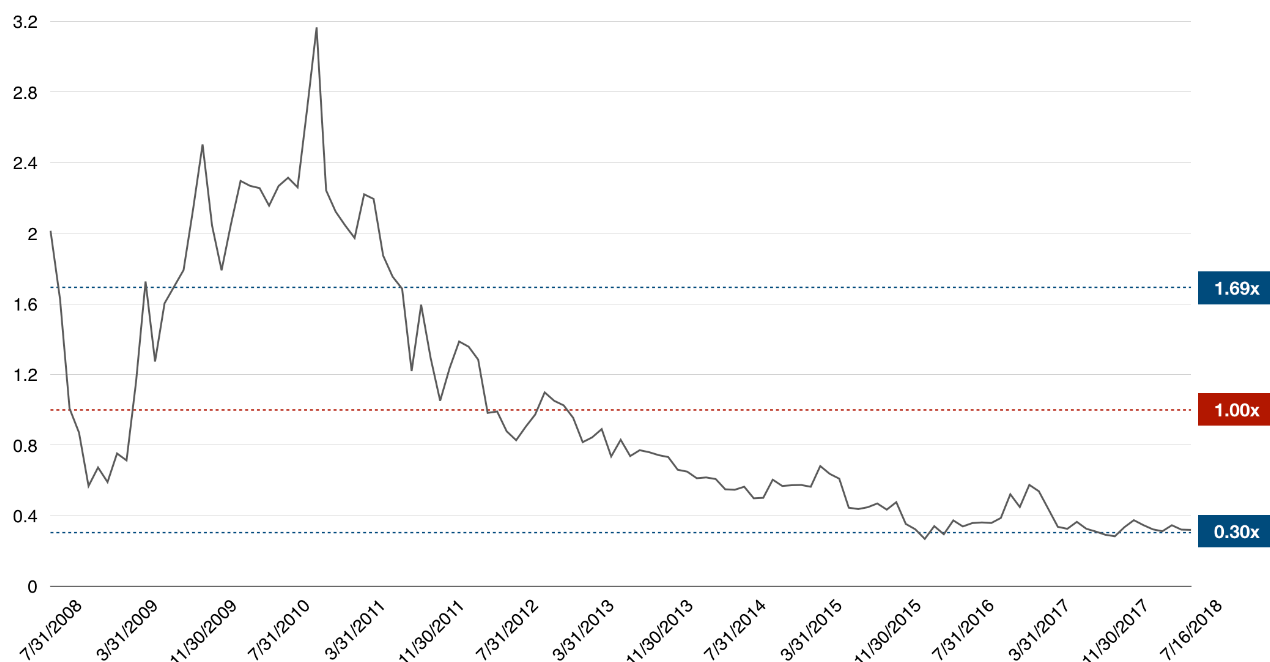
Although prices of Emperor Watch & Oriental Watch have recovered significantly, Hengdeli Holdings have not. Valuations remain lacklustre. On the surface it business operations has not turned around.

Hengdeli underwent a significant business transformation in 2017 where the mainland retail business was sold to the controlling shareholder for RMB3.5 billion. The proceeds were used to pay a special dividend and retire debt.

FY 2017 financials thus reflect several one offs (the cost of the buyout and redemption of bonds) and former interest expense that no longer exists from the redemption of debt.

Stripping these out, Hengdeli is in fact close to breakeven and is poised to benefit from the same tailwinds as Emperor Watch and Oriental Watch.

Hengdeli has also exploited the decline in share price. During the period from May to June 2018, the company bought back a total of 13.46 million shares and cancelled 9.24 million of the shares bought back.



Hengdeli Holdings now trades at 0.34x book value and has a net cash position. Net cash is 103% of its market capitalisation. We think that the valuations are extremely attractive at current prices.

Ending Comments

Equity markets have finally taken a breather after rising continuously since Trump's election. We have taken the opportunity to reallocate our portfolio. While valuations in our core markets continue to remain reasonable, we remain cautiously optimistic on the outlook in the coming months.

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