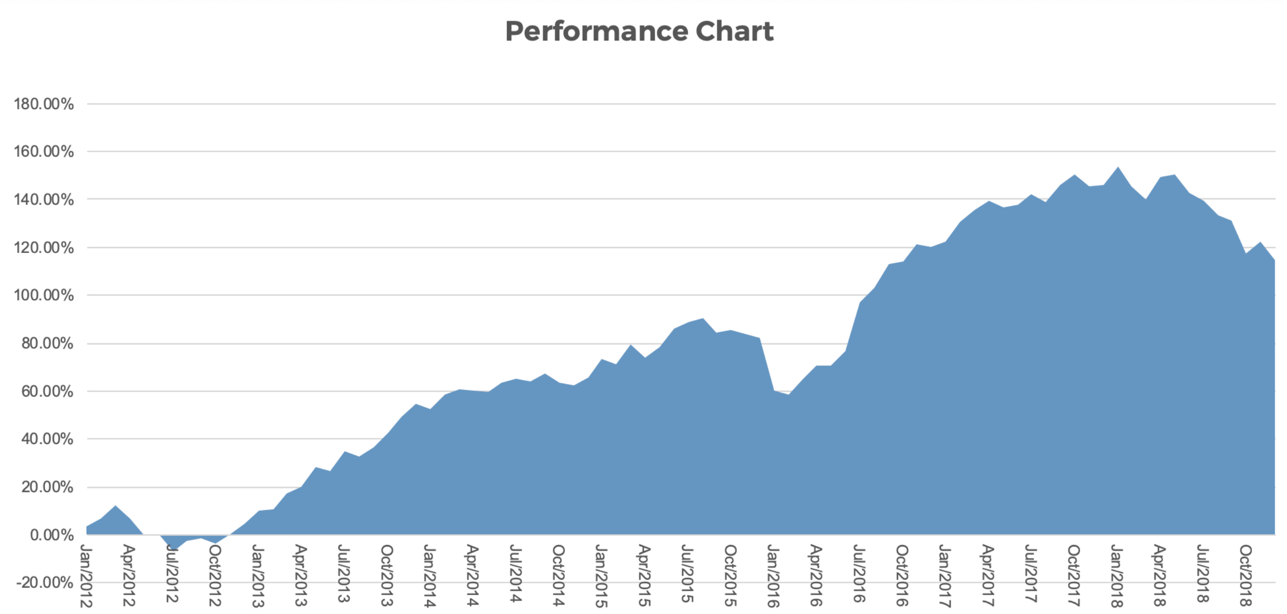
HERITAGE
VALUE FUND

Heritage Global Capital Fund
Investment Memo
December 2018

2018 Year End Letter



Year	Heritage Global Capital Fund	MSCI Asia ex-Japan Index (SGD, Dividends Reinvested)	MSCI World Index[1] (SGD, Dividends Reinvested)
2012	+4.58%	+22.73%	+9.74%
2013	+47.98%	+3.39%	+31.57%
2014	+7.09%	+4.96%	+10.68%
2015	+9.91%	-8.88%	+6.63%
2016	+20.73%	+5.71%	+10.37%
2017	+11.80%	+42.12%	+13.64%
2018 (YTD)	**-12.80%**	**-13.93%**	**-6.62%**
Cumulative	**+114.41%**	**+50.19%**	**+90.34%**
Annualised	**+11.51%**	**+5.98%**	**+9.63%**

[1] The MSCI World Index has a 62% weightage towards the US. We have added it for your reference.

For the twelve months ending December 2018, Heritage Global Capital Fund has returned -12.80% in SGD terms. Our benchmarks, the MSCI Asia ex-Japan Index and MSCI World Index (Rebased to SGD with dividends reinvested) returned -13.93% and -6.62% respectively.

Since January 2012, the fund's investment strategy has generated a cumulative return of +114.41% and an annualised return of +11.51% net of fees. This compares with the MSCI Asia ex-Japan Index and MSCI World Index (rebased in SGD terms) which has returned a cumulative return of +50.19% and +90.34% and an annualised return of +5.98% and +9.63% respectively.

Market Review

We have provided below a review of significant transactions in relation to the fund's operations.

A brief review of our thinking is relevant. Our philosophy is to never let a good crisis go to waste. While no recession has yet hit, the global markets have certainly corrected dramatically in 2018.

Not all businesses react in the same way to a market decline. In 2016, banking stocks in Singapore declined dramatically because of fears of their exposure to the oil and gas industry. This time, they only corrected marginally as business fundamentals remained robust with net interest margins increasing and healthy loan book growth.

Our modus operandi will be to reallocate capital to the positions with the greatest risk/reward potential. The fund has been extremely active in the last 3 months reallocating our capital. Although these may not be obvious from our results yet it will become clearer in the future as we weight our portfolio to higher quality names at bargain prices.

If this sounds familiar, it is because this was what we did early in 2016. The downturn set the stage for us to reallocate capital to high-quality blue-chip names at bargain prices.

Intelligent investing is all about focusing on the long term. In this regards, the fund's core philosophy remains unchanged – focus on protecting the downside, which we define as permanent losses of capital and the upside will take care of itself.

The last twelve months have been treacherous for those who have been less prudent (Noble bonds, Hyflux securities, Crypto-currencies etc). We have resisted these overtures and kept to our investing framework that has served us well thee past years.

Buying good quality companies at reasonable prices and focusing on managing the downside risk is not always be a rewarding or exciting strategy in the short-run.

As Warren Buffett is fond of saying however, it is only when the tide recedes will you see who is swimming naked. In this regard, we are confident of weathering this temporary storm to deliver satisfactory long term returns in the coming years.

Just a note, positions that are in the process of being sold will be discussed when it is fully sold in the subsequent mid-year review.

Review of Divestments

PetroChina

During the middle of December 2017, Brent oil prices touched a high of US$65. Energy is normally a late market and economic cycle out-performer. We researched potential investment candidates in the upstream segment of the oil & gas industry. PetroChina fit our criteria of both having a strong balance sheet as well as being attractively priced.

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 to stabilise oil prices. Potential supply disruptions also loomed.

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

PetroChina has significant exposure to the upstream exploration and production business. They were a major beneficiary if oil were to move higher. Every increase of US$5/BBL in oil would prices would lead to a 92% increase in FY18E EPS if crude oil prices are above US$65.

Furthermore, its oil reserve potentials were not accounted for in its balance sheet. Given the attractive risk/reward opportunity and high sensitivity to oil prices, we felt that PetroChina was an ideal investment candidate.

We acquired our position in PetroChina at an average price of HK$5.41 in December 2017. These shares were sold at an average price of HK$6.00 in September 2018, realising for the fund a gain of **+12%** with dividends included.

The shares were divested to redeploy capital into other opportunities that had significantly better risk/reward ratio.

Pershing Square Holdings

Pershing Square Holdings Ltd is a closed-ended hedge fund vehicle managed by famed activist investor Bill Ackman. The fund itself had debuted to great fanfare in 2014 at an offering price of $25 before tumbling to $13 to $15 when we first initiated coverage.

Pershing Square Holdings was suffering a bad bout of performance after a highly successful run over many years. More importantly, it represented a basket of highly liquid stocks trading at a significant discount to its net asset value that allowed us to ride any recovery in the main fund, as well as a narrowing in discount when fund performance picked up.

We acquired our position in PSH at an average price of US$14.05 from September 2017 to January 2018. These shares were sold at an average price of US$14.36 in September 2018, realising for the fund a gain of **+2%** with dividends included. The shares were divested to redeploy capital into other opportunities that had significantly better risk/reward ratio.

Oriental Watch

We spoke about the luxury watch retailers quite extensively in our recent letter - 2018 Mid-Year Outlook and our article published by The Edge, which we have attached in our email.

Established in 1961, the Oriental Watch Holdings was the first watch retailer listed on the Main Board of the Hong Kong Exchange. Luxury watch retailers like Oriental Watch were hard hit by the corruption clampdown in China and the corresponding slowdown in tourism in Hong Kong.

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. Improved earnings from revenue increases and cost reductions in rent drove ultimately drove prices higher.

We acquired our position in Oriental Watch at an average price of HK$1.77 over the course of July 2017 to January 2018. These shares were sold at an average price of HK$2.12 in August 2018, realising for the fund a gain of **+21%** including dividends.

Texwinca

Texwinca is a Hong Kong listed textile company. It provides high end fabrics to brands like Uniqlo, Nike, Adidas etc. Texwinca also operates its own retail stores "Baleno" which were facing negative headwinds in China's competitive retail market.

By the time we initiated coverage of the stock, Texwinca was trading at very depressed valuations having fallen almost 50% from its peak. It was very much a Graham type "net-net" stock with substantial assets and cash flow operating in a challenged industry.

It became apparent to us in the second half of the year that the intensity of the trade war would be much greater than initially anticipated. Secondly, a movement of suppliers to countries such as Vietnam would provide additional headwinds in the future.

We acquired our position in Texwinca over November 2016 to January 2018 at an average price of HK$4.64. These shares were sold at an average price of HK$3.10 from September 2018 to October 2018. Dividends received reduced our overall loss to -**28%**.

We sold our position in Texwinca in light of these factors and to redeploy capital into other opportunities that had significantly better risk/reward ratio during the last three months.

Investment Opportunities

Chinese Automobile Manfacturers (BAIC Motor, Guangzhou Motor, Brilliance Auto)

BAIC – JV partner of Hyundai & Mercedes Benz
Guangzhou Motor – JV partner of Fiat, Honda, Isuzu, Mitsubishi, and Toyota
Brilliance Auto – JV partner of BMW

The fund made significant investments into the three separate China automobile manufacturers. The sharp change in sentiment of the automobile manufacturers was a good reflection of how equity markets can react irrationally on both the upside and downside in short periods of time.

China annual automobile sales fell for their first time in two decades in 2018 – a sharp contrast to the double-digit growth that analysts were envisaging at the start of the year.

Compounding these problems were the new joint-venture rules that allowed foreign carmakers to take larger stakes in their partnerships with local manufacturers. As per Bloomberg's article

"Brilliance China Automotive Holdings Ltd. sank by a record after it agreed to give BMW AG control of their joint venture, diminishing the Chinese carmaker's exposure to future growth in the world's largest auto market. "

Similar fears regarding BAIC Motor also led to downward pressures on its share price.

There are several points we would like to raise:

- The largest automobile makers are increasing their exposure to the Chinese market.
- This is not to say they do not envisage short term headwinds. However, as businesses, they have to invest for the long-term which is exactly what they are attempting to do

The three auto manufacturers would have commanded a steep premium in price and valuations based on the future prospects just 6 months ago. By September, the sentiment had completely swung to fear and pessimism.

At the time of the Bloomberg article cited above, BMW had agreed to pay the Chinese automaker $4.1 billion for its 25 percent stake in the venture, valuing the 50 percent currently owned by Brilliance in the venture at $8.2 billion. Brilliance on the other hand was only trading at a market value of $5.2 billion representing a steep discount rarely seen in the markets except in extreme pessimism.

Based on prices paid, our returns on the three automakers will be highly profitable even if conditions return to normalised conditions. In the short run, the Chinese government is already moving to stimulate the Chinese economy (domestic consumption) and should provide near time floor of carmakers in the coming year.

Hang Lung Properties

We spoke about Hang Lung Properties extensively in our letter - Q1 Review – Property or Equities for The Long Run?.

Hang Lung was not spared in the sell-off and we moved to add to our positions given the highly attractive valuations and dividends paid.

Over the course of 2018, Hang Lung Properties also saw its insiders (the controlling shareholder Ronnie Chan and its deemed interest) increase their stake significantly in Hang Lung Properties.

SOHO China

We first wrote about SOHO China in our 2017 Year End Review. Back then, we disposed of our shares at $4.74.

We increased our position at significantly depressed prices in the second half of 2018 as prices plunged fell to all-time lows of below HK$3.

APT Satellite

APT Satellite operates in-orbit of satellites around earth and their corresponding ground TT&C (telemetry, tracking and command) systems and earth station. They provide “one-stop-shop” satellite transponder leasing, broadcast, Teleport and Network, as well as data center services to broadcasters and telecommunication customers.

They offer the services to a wide range of applications including video distribution, Direct-To-Home TV, cellular backhaul, corporate network, maritime and aeronautical mobility services.

We were attracted to APT for its strong free cash flow over the next few years as capital expenditure spending winds down as it satellite replacement program is near completion.

Ample free cash flow generation provides good support for dividend payments in the coming years. APT has recently increased its dividend in the last financial result and we expect this to continue in the coming year.

Lian Beng

With the recovery in Singapore's property sector, we have been selectively investing into construction companies that we believe would be able to ride the construction wave from the increase in demand from both the public and private sector.

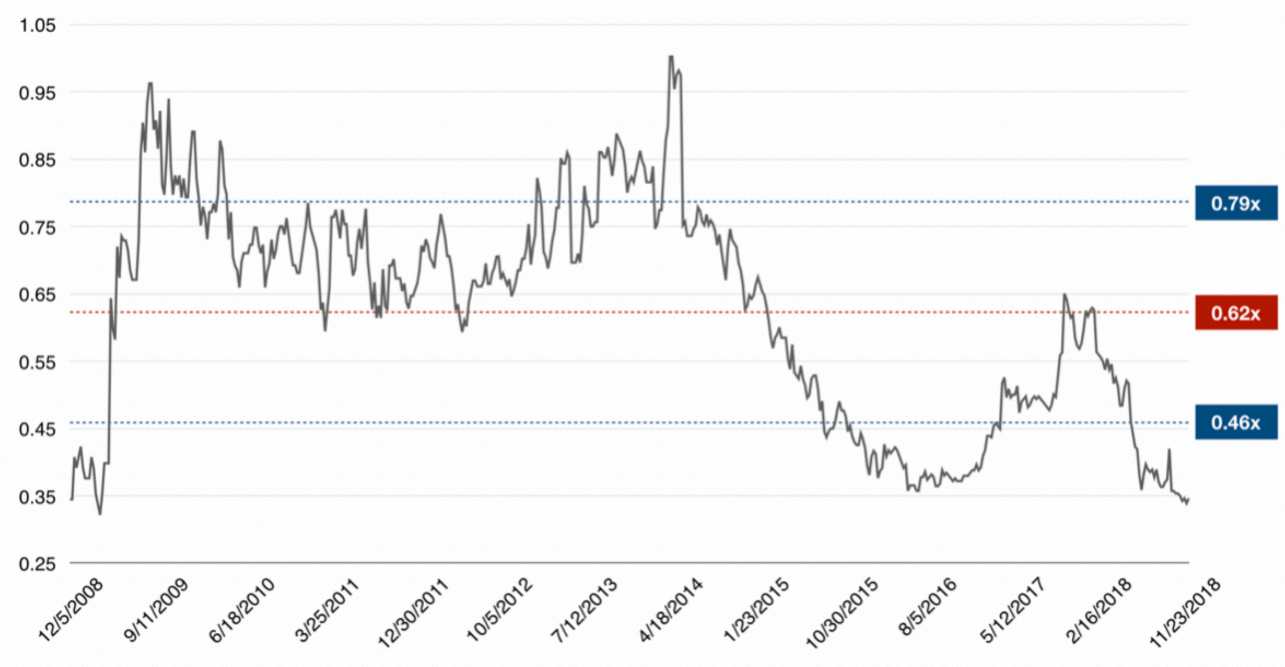
Total construction demand, which is the value of construction contracts to be awarded, is expected to be between S$27 billion and S$32 billion this year, despite additional cooling measures in the private property market and the delay in construction of the high-speed rail between Singapore and Kuala Lumpur last year. This represents a 23% increase in construction demand compared with the year before.

One such company that we have invested in would be Lian Beng Group. We recently presented this company at The Edge Singapore conference in December, the article can be found as attached in the email.

Lian Beng's construction order book is at a record level of S$1.29 billion, which would provide 5 years' worth of revenue visibility, using FY18 revenue numbers as a gauge. Furthermore, with Lian Beng being both a contractor and developer, this would help it ride out the stiffer competition in the construction sector due to government regulations and competition from Chinese construction firms.

Additionally, we like Lian Beng for its strong partnerships with Oxley. By doing so, they are able to diversify their property development over several projects such as the recent Rio Casa and Serangoon Ville, where they only own 20% of each project and are insulated from being overly exposed to one project.

Lastly, Lian Beng's investment property segment, which recently purchased Wilkie Edge, provides a steady rental income, which adds to its recurring cash flow helping smooth out the lumpiness in construction earnings.



Lian Beng is an attractive investment opportunity, where it is currently trading at 0.35x book value, a 44% discount to its historical average of 0.62x book value. Furthermore, the Ong family has bought back roughly 1 million shares at an average price of S$0.47 in the last few months. This gives us a good indication of the alignment of interest between management and us minority shareholders.

Yanlord Land

Yanlord Land is a real estate developer based in China that focuses on developing high-end residential and commercial property projects in strategically selected key high-growth cities in China located within the Greater Bay Area. Below are 3 main points that we find Yanlord Land an attractive investment candidate.

1. **Greater Bay Area as a beneficiary of potential policy changes**. The Greater Bay Area (including Guangdong-Hong Kong-Macau) is expected to benefit from expected policy changes that will position it competitively from other bay areas. While there appears to be some delays in the announcement of a major economic integration plan by the government, we expect impending initiatives to be structurally positive for domestic property demand. Infrastructure connectivity will also be a catalyst for the Greater Bay Area.

Efforts to improve transport infrastructure and make inter-city transport more convenient will raise accessibility in this area significantly. Therefore, this will attract investments and create employment in the area. Additionally, this would result in an influx of people to move into this area. This would benefit Yanlord Land given its presence in Shenzhen and Zhuhai, which on estimate forms c.22% of its land bank.

2. **Continued urbanisation key to longer-term growth**. Urbanisation rates can be expected to rise, spurring demand for residential property over the medium- to long-term horizon.

   The Yangtze River Delta has recorded urbanization rates of 70.5%, well above the national average of 57.3% in 2016. Research has shown that as the rate of migration reaches between 30%-70%, there will be an accelerated migration of population towards city clusters. The 5 major city clusters which include Yantze River Delta and Pearl River Delta (party of Greater Bay Area) will make up 50%-60% of China's total population. This will benefit Yanlord Land as these are 2 of the core markets for the Group.

3. **Yanlord's debt issue.** While some investors may be worried about the company's high debt level, where its gearing ratio stands at c.91.2% due to land acquisitions. In our opinion, this is not a major concern given how Yanlord's debt has a financing cost of just over 5%, which is significantly cheaper than the 12% to 14% paid by some other Chinese developers. Furthermore, a significant portion of the debt is only coming due in a 2 – 5 year time frame.

Given such growth prospects, we find that Yanlord trades at undemanding valuations – a 58% discount to book value. Furthermore, management's interest is closely aligned with shareholders where he owns c.70.0% and has bought back approximately 27.8 million shares at an average price of S$1.72.

Ending Thoughts:

The fund's current portfolio is well positioned, and we are optimistic about the long-term returns going forward. Of note, we have taken the recent downturn to reallocate a range of high quality businesses with strong financial positions that will benefit when market sentiment recovers.

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