Property or Equities For The Long Run

Since inception in November 2016, the Heritage Global Capital Fund has returned +10.05%. The investment strategy has been built and refined over the years. It was first implemented in January 2012 in a private investment vehicle prior to the fund's inception.

Taking into account of both records, the fund's investment strategy has returned a cumulative +135.50%, or +17.72% annually.

The track record of the investment strategy prior to the fund's inception has been discounted for the current fee structure of the fund. It has also been verified by Equinox, an independent fund administrator.

Going forward, investors can expect a review of the fund's investments semi-annually. In the interim, we will also be disseminating memos to keep investors up to date with important investment-related matters.

Property or Equities – Which Make For A Better Investment?

We are often asked whether property or equities make better investments. We submit to you that this is a false choice. Neither asset class on its own makes for a better investment. What matters is the price paid (valuation).

More importantly, one must thoroughly understand the prerequisites needed to succeed in that particular investment.

We view investments in hard assets such as property favourably. In fact – many of our portfolio investments are in property related businesses. If the property market is healthy, our investments benefit correspondingly.

We look for well-financed firms trading at conservative discounts to our appraisal of their net asset value (NAV). Many of these firms are still majority owned by their founding families. This adds an additional layer of security as a huge chunk of their financial net worth is tied to these businesses.

In 2016, the volatility in the Chinese markets spilled over to Hong Kong and Singapore.

This afforded us the prime opportunity to invest in businesses trading at historically low valuations. One such firm was **Hang Lung Properties**.

Hang Lung Properties

Hang Lung is not your typical property developer. Its primary business model is to grow its cash flow through the long term holding and development of the best commercial properties in Tier 1 and 2 cities in China such as Shanghai, Tianjin and Dalian.

It has done so conservatively and carefully, placing great emphasis on timing the ebbs and flows of the property cycle. Hang Lung has operated with zero or negligible net debt for the better part of the last decade, a rarity among firms that are often highly leveraged in the property business.

Much of its success can be attributed to the disciplined management of the firm. The firm has been helmed by Ronnie Chan for the last 25 years.

A Case Study in Timing the Property Cycle

In the years before the Asian Financial Crisis in 1997, Hang Lung was busy selling noncore properties in Hong Kong to raise cash. They refused to bid for land, which had skyrocketed in prices. This was despite criticism that they were overly conservative and out of sync with the times.

When the financial crisis hit, they were well prepared. Over 1999-2001, Hang Lung armed with its war chest, acquired four major sites in Hong Kong when sentiment was at an all-time low. This time, critics accused it of being overly optimistic and aggressive.

Over the last decade, the sites acquired became developments such as The Harbourside and Long Beach.

When property prices recovered, these developments proved to be immensely profitable. To date, they have netted Hang Lung over HK$30 Billion in pre-tax profit.

Instead of ploughing the money into pricey bidding wars for land in Hong Kong, Hang Lung invested these profits into acquiring land in China when sentiment was weak.

They took the long term view, buying the best locations in Tier 2 cities that were relatively neglected compared to Beijing and Shanghai.

As a result of its efforts, rental revenues in the last financial year from China now makes up over 50% of its leasing revenue (total leasing revenue was HK $7.74 billion in FY 2016). Hang Lung expects this rental revenue to continue increasing as these properties mature and China continues its ascent.

A short word on China. In the next ten, twenty and even thirty years, we are extremely bullish. The scale and intensity of its rise to date are truly astonishing. No doubt, at some point in an indeterminate future, it will experience recessions and downturns.

This is a natural by-product for those who choose to adopt a market-based economy.

Lest we forget, the US has itself been through thirteen recessions and one great depression since the 1920s. It has gone through one great civil war that almost tore the country asunder. And yet it thrives today.

Some perspective is thus in order when pundits declare the pending collapse of China.

Investing in Property through Stocks

The long-term success of Hang Lung over the last two decades has been rooted in its ability to think long term, act prudently and to react accordingly.

When others were aggressive, they increased caution and fortified their balance sheets. They acted in a contrarian fashion, selling when prices were high and sentiment optimistic, and buying when prices were low and sentiment pessimistic.

Investors would note that these same traits are equally important for long-term success in investing in property directly. They are in fact one and the same thing.

They key difference here is the ownership structure we have undertaken. Instead of investing directly in property, we tend to prefer to invest indirectly, partnering with immensely capable management like Ronnie Chan when the price is right. If property prices rise, Hang Lung will no doubt benefit in equal proportions.

One added advantage of utilizing such a method is tax efficiency. We pay zero capital gains and dividends taxes for our investments into Hong Kong and Singapore property related companies. Transaction costs are negligible, especially for long-term investors.

Getting a Discount from Fair Market Values

By buying when prices are cheap and out of favour, investors receive two important benefits – a higher dividend yield and a discount to the book value of these assets.

In the case of Hang Lung, two main assets make up the bulk of its net worth. The first – its collection of investment properties which are re-valued annually.

Generally, if one were to pay fair market value for these assets, the equivalent rental income on these assets would be in the region of 4.5%.

However, by paying a significant discount of 60% of book value, the equivalent rental yield that we receive is closer to 7.5%. This increased rental yield naturally flows to us through the higher dividend yield paid to shareholders.

Equally compelling is the discount which applies to the stated inventory of Hang Lung which is made up of the development properties yet to be sold.

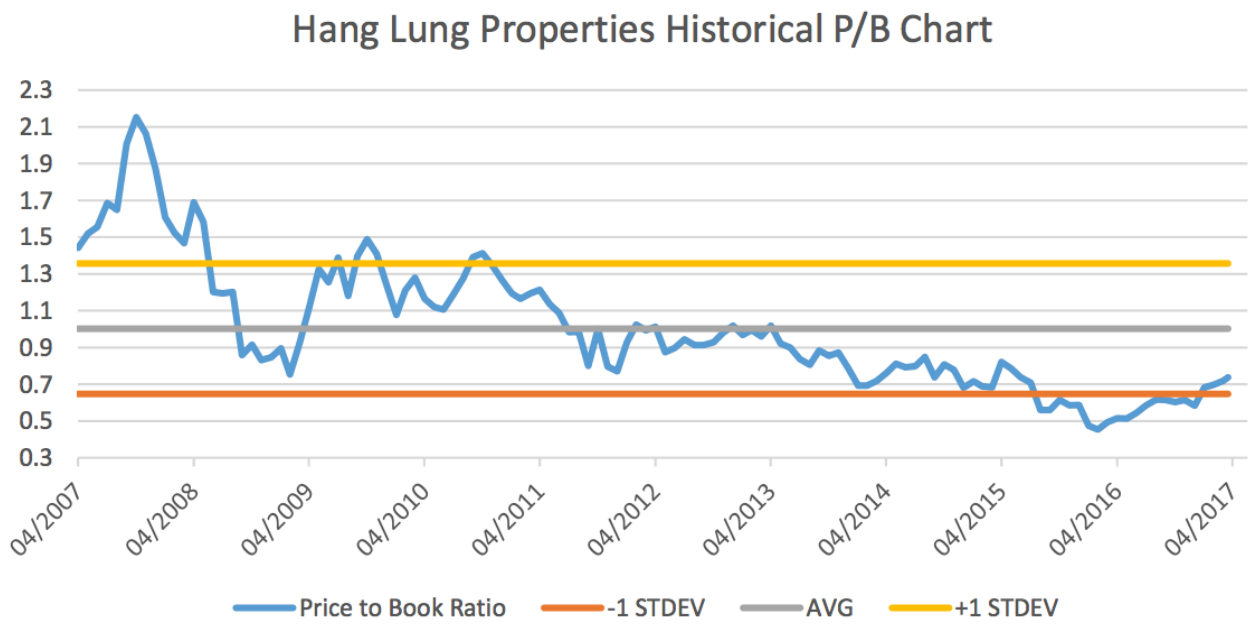
Unlike investment properties, they are not revalued yearly but are recorded at cost according to accounting rules. In other words, these properties are valued at levels close to that almost a decade ago.

The difference between the carrying value of these properties and their actual market values are only booked when sold.

Investors thereby receive a "double discount" compared to buying these properties at fair value in the open market today.

They are not only able to buy Hang Lung at a discount to current book value, but also do so with the inventory portion of Hang Lung's net worth booked at significantly cheaper prices than their true market values today.

In 2013, management indicated that the market values of their completed properties for sale were over three times their stated book values. Given the run-up in prices the last three years, these properties are worth considerably more today.



Our completed Hong Kong apartments for sale are recorded at cost according to accounting rules. On the books the value is around HK$5.7 billion. At today's somewhat weak market sentiment, they should still be worth perhaps ***HK$20 billion***.

— Hang Lung Properties Annual Report 2013

Investment is Most Profitable When it is Most Business-like

It is our firm belief it will serve investors the best to think like long term business owners. Investing in equities, no matter the amount really entails buying a part ownership of a business.

Anchoring ourselves to sound and prudent business principles have allowed us to keep a steady hand throughout turbulent times and will continue to do so in the coming years.