Asia Pacific UCITS Fund Commentary 1Q18

Longleaf Partners Funds

For Professional Investors Only

For the quarter ending March 2018, the Asia Pacific UCITS Fund was flat, in-line with the MSCI AC Asia Pacific Index. Exchange rate movements benefitted the portfolio, but the index gained an additional 100 basis points from currency conversion given its higher weighting in Japan. Volatility continued to provide us with opportunities to allocate capital into existing, as well as new, investments during the quarter. While our cash levels in April are at the lower end of our historical range, our on-deck list has become more robust, as a number of opportunities pulled back into our target price range during the first quarter.

Portfolio Returns at 31/03/18 – Net of Fees

	1Q18	1 Year	2 Year	3 Year	Since Inception 02/12/14
APAC UCITS (Class I USD)	0.00%	19.63%	22.49%	13.91%	12.67%
MSCI AC Asia Pacific Index	-0.04%	20.30%	18.50%	8.25%	9.07%
Relative Returns	+0.04%	-0.67%	+3.99%	+5.66%	+3.60%

Selected Indices	1Q18	1 Year	2 Year	3 Year
Hang Seng Index*	0.92%	29.46%	24.96%	10.47%
TOPIX Index (JPY)*	-4.81%	15.49%	14.92%	5.48%
TOPIX Index (USD)*	0.89%	21.03%	18.27%	9.84%
MSCI Emerging Markets*	1.42%	24.93%	21.03%	8.81%

*Source: Bloomberg; Periods longer than 1 year have been annualized

Market Commentary

After a strong start to the year on the back of U.S. tax reforms, global equity markets experienced a violent sell-off in early February, driven by inflation worries and the prospect of higher interest rates. Compounding the volatility, U.S. President Trump's threat of imposing tariffs increased fears of a trade war with Asia. While this sell-off may have felt like a seismic event for the U.S. capital markets, we are accustomed to a heightened level of volatility across the Asia Pacific markets. We view the recent market pullback as an opportunity to reposition the portfolio into strong businesses, managed by owner-operators, trading at a temporary discount to long-term intrinsic value.

Information Technology stocks, which drove strong index performance in 2017, began to show signs of stumbling in the quarter. Regulatory pressure in the technology sector has increased as concerns over market dominance, data privacy, tax avoidance and artificial intelligence safety have all risen. Despite these pressures, Info Tech outperformed the broader MSCI Asia Pacific Index in the quarter, but Health Care led the index. Our underweight exposure to these two sectors – two of only four positive performing sectors in the quarter – weighed on relative returns in the period.

Most sectors declined in the quarter, creating the opportunity for us to add to existing holdings that became more heavily discounted, despite strong fundamentals and an improving outlook. Price weakness within one of the worst performing sectors of the index, Telecom Services, and within the worst performing country in the region, Australia, created the opportunity for us to initiate a new position in Australian telecom operator Vocus Group, discussed below.

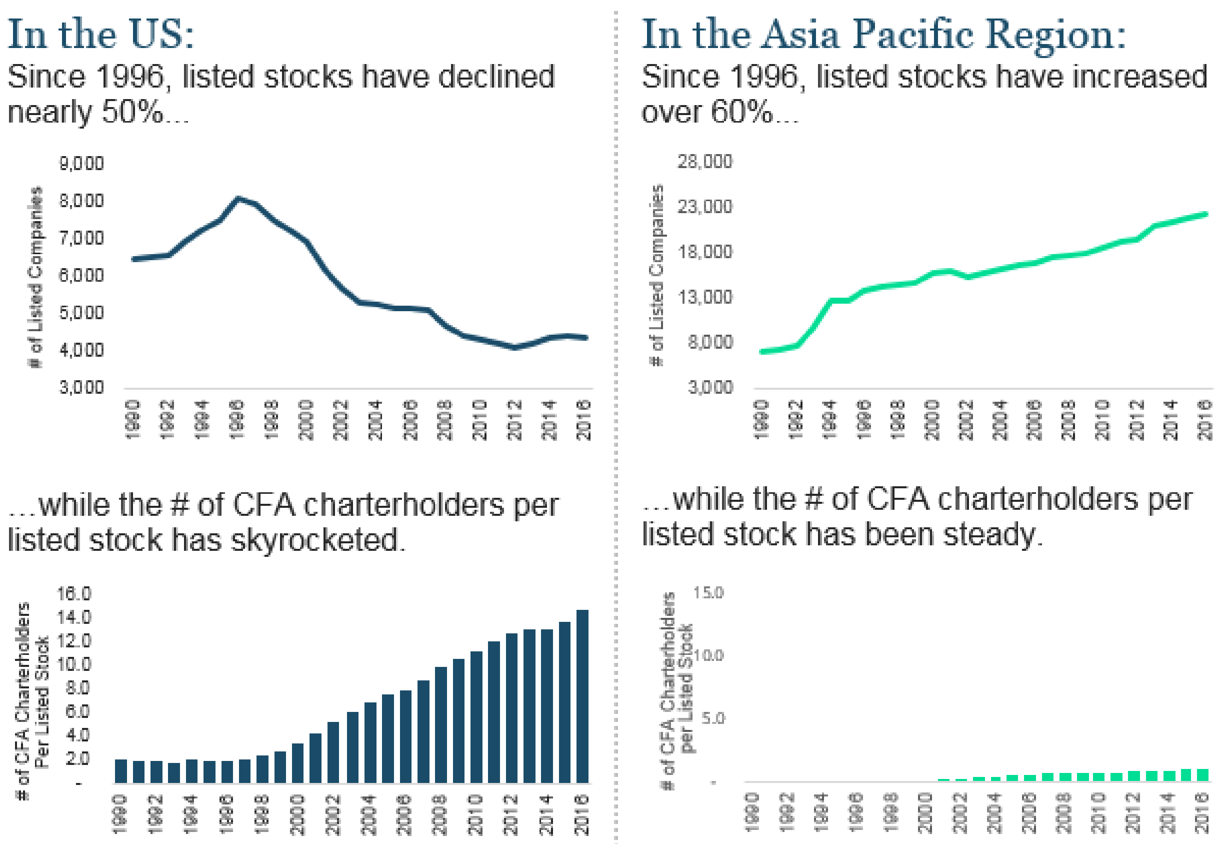
The table below compares key returns drivers in the past five years for various global indices. Notably, over half of MSCI USA returns have been driven by Price-Earning (P/E) multiples re-rating over the last 5 years, with earnings growth only contributing 23% of the returns. On the other hand, earnings growth has been the key driver of returns in Asia, accounting for almost 90% of returns. In Japan, the contrast is even starker, with close to 140% of the returns being driven by earnings growth, as P/E multiples de-rated in the last 5 years. As a result, Asian markets are relatively less exposed to the risk of valuation multiple contraction, as we move from an ultra-low interest rate environment. Additionally, revenue growth, rather than buybacks or cost reductions (which are often optimal strategies for individual companies, but rarely for entire markets), has been the primary driver of Asian earnings growth. We believe that the Asia Pacific region offers a robust earnings base and cheaper valuations relative to the other regions.

5-Year Contribution to Return (%)*

	Contribution to Return				Total Gross Return	
Index	**EPS**	**Dividend**	**Currency**	**P/E**	**USD**	**Local**
MSCI USA	22.6	21.2	-	56.2	86.1	86.1
MSCI World	33.3	31.8	(11.8)	46.7	63.4	70.9
MSCI Europe	33.8	56.9	(21.9)	31.2	40.1	48.9
MSCI Hong Kong	52.5	39.7	(2.9)	10.7	54.1	55.7
MSCI AC Asia Pacific	88.4	44.5	(36.0)	3.1	45.7	62.2
MSCI Japan	138.9	31.2	(36.7)	(33.4)	55.7	76.1

Source: Factset, Bloomberg, Southeastern; *Prices and returns through 31/03/18 and earnings data through 28/02/18.

The relative attractiveness of the opportunity set in Asia is also illustrated in the charts below. The number of listed companies in the U.S. has halved since 1996, while the median market cap has increased, and the number of CFA charterholders (used here as a proxy for investment professionals covering the universe) has increased. Combine this with the increasing passive share of the market in the U.S., and the result is an increasing number of professionals competing within a shrinking opportunity set. On the other hand, the number of listed companies in Asia has nearly doubled over the same period. Asia remains the most dynamic region globally for IPOs. The number of CFAs per listed company in Asia is around 1/8th that in the U.S., and the quality and quantity of sell side research coverage of Asian companies is generally inferior to that of the U.S. As a result, Asian markets should systematically generate more inefficiencies and allow unconstrained, yet disciplined, bottom-up fundamental investors to uncover more discounted opportunities.

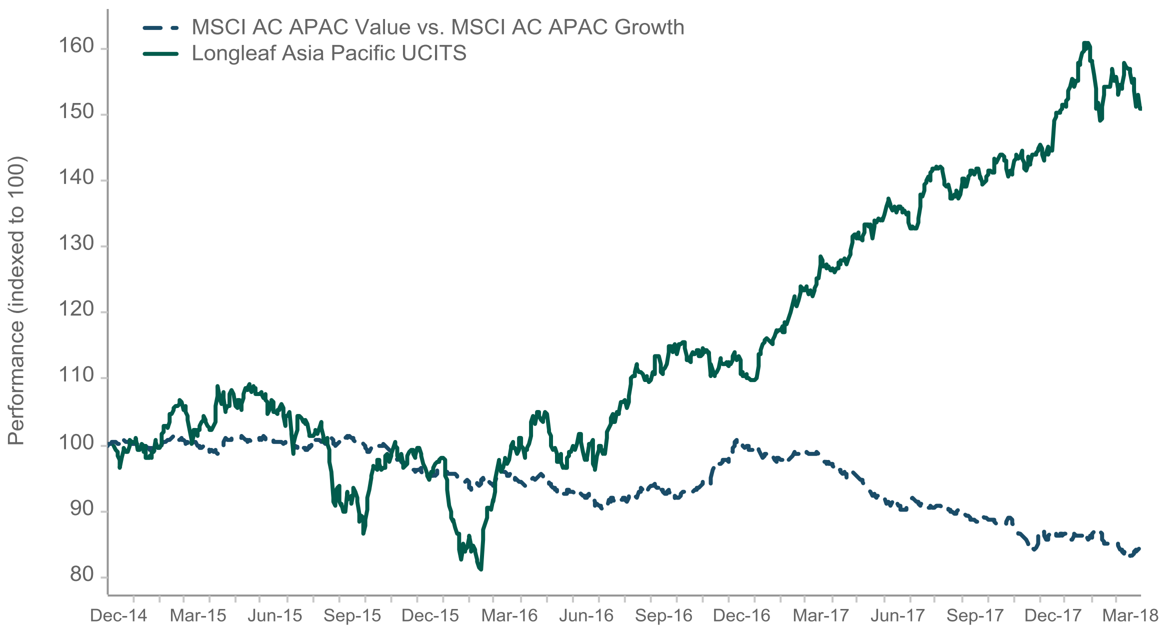


Source: World Bank and CFA Institute – Annual Data; Regions are based on CFA Institute regional classifications.

As shown in the chart below, growth has continued to outperform value within the MSCI AC Asia Pacific Index, primarily driven by Info Tech stocks. Tencent, Alibaba, Taiwan Semiconductor Manufacturing Company (TSMC) and Samsung have accounted for the majority of the index returns over the last two years. Our value investing discipline does not naturally lend itself to investing in such technology stocks, which typically have higher valuations and lack sufficient margin of safety. Despite these headwinds, we have still been able to deliver attractive absolute and relative returns by concentrating our investments in competitively entrenched businesses run by owner-operators with a margin of safety regardless of geography, sector, benchmark or market capitalization.

MSCI AC Asia Pacific Value vs. Growth Relative Performance

02-Dec-2014 to 30-Mar-2018 (Daily)



Source: FactSet Prices

1Q18 Performance Review

	Contribution to Portfolio Return (%)	Total Return (%)
Top Five		
Vipshop	+2.32	+43
AIN Holdings	+0.82	+26
MinebeaMitsumi	+0.23	+2
JINS	+0.07	+5
Toyota Motor	+0.01	0
Bottom Five		
Man Wah	-0.51	-16
Healthscope	-0.38	-9
Speedcast	-0.34	-6
Vocus Group	-0.33	-8
CK Hutchison	-0.30	-5

Top Contributors

Vipshop (+43%), a leading online discount retailer for brands in China, was the top contributor for the quarter. Total revenue in the fourth quarter of 2017 increased 27% year-over-year (YOY), above the company's prior guidance. Average revenue per user increased 22% YOY, while the number of active customers increased by 4% YOY. Their gross profit margin contracted as management continued to reinvest profits for faster growth. However, positive operating cost leverage resulted in a better than expected operating margin. Vipshop's internet finance unit is expected to be spun off in the coming quarters, releasing associated working capital and alleviating some cost pressure. JD.com and Tencent's purchase of a 12.5% combined stake in Vipshop in December cemented a strategic cooperation with these two dominant businesses that should be highly beneficial to Vipshop over the long-term. In March, JD.com installed Vipshop's portal on the main page of their mobile app. Beginning in April, Vipshop will benefit from WeChat's one billion active users being able to click through to Vipshop directly from the WeChat app. Longer-term, cooperation with JD logistics should create further synergies for Vipshop.

AIN Holdings (+26%) is the largest prescription pharmacy chain in Japan and was another positive contributor in the quarter. As you might recall, this is our second time owning AIN. We love allocating capital to "recycled" companies, given our continuous institutional knowledge of the business and the people. The Japanese prescription dispensing pharmacy sector is highly fragmented with over 58,000 pharmacies, the majority of which are run by single-store operators. AIN, with roughly 1,000 pharmacies and 3% market share, is the largest and most profitable pharmacy chain in Japan. CEO Kiichi Otani owns over 9% of the company. Despite regular downward drug price revisions by the Japanese government, the dispensing pharmacy market is still expected to grow 3% to 5% annually, as prescription volumes have increased with an aging Japanese society and prescription fulfilment has moved from hospitals to pharmacies. The most recent price revision which came into effect this month will likely be more punitive for the small operators. AIN remains confident in its ability to overcome the price revision impact over time, as it has successfully done many times in the past. With a net cash balance sheet and competitive advantage from scale, AIN should be in a good position to increase their penetration of more profitable and larger scale pharmacies within large hospitals. AIN is expected to ramp up organic growth via on-site hospital pharmacies while also acquiring under-performing pharmacies at low single-digit EBITDA multiples.

MinebeaMitsumi (+2%), the Japanese manufacturer of high precision equipment and components, was a positive contributor in the quarter. MinebeaMitsumi reported another strong quarterly result and increased its full-year results estimate for the third time this fiscal year. The company's precision ball bearings sales were up 16% YOY in the quarter. The company's average monthly external shipment volume reached 193 million units per month this quarter, up YOY for 21 quarters in a row. Given the strong demand and limited capacity, management is increasing pricing for ball bearings and expects its profitability to increase in the next fiscal year. The Mitsumi segment reached another record high profit after the acquisition of the business in January 2017. While the recent Chinese New Year period may create some seasonal production volatility, the outlook for the Game Console business, which supplies Nintendo with the Switch game console, remains strong and demand is expected to grow next fiscal year.

JINS (+5%), the Japanese optical retailer with large scale advantage from its 20% volume share in Japan, was also a positive contributor in the quarter. The company's differentiation strategy in China to fight against copycat competitors is contributing to the existing store sales growth. In the U.S., new designs that cater to the local market helped improve operating results. Operations in both China and the U.S. are performing above the company's initial expectation, and JINS is scheduled to open its first retail store in the Philippines this month. In Japan, however, unit prices are facing some headwinds from negative mix shift, despite strong volume growth. As a result, domestic same store sales in the first half of the financial year fell below target. JINS revised down its full financial year forecast in early April, but left the second half estimate unchanged. The strong same store sales in the first month of the fiscal second half (March +10.1%) are showing some early signs of recovery.

Top Detractors

Man Wah (-16%), the leading recliner and sofa manufacturer in China, was a recent addition to the portfolio (4Q17) and was the largest detractor in the quarter. Fears of a potential trade war between the U.S. and China weighed on Man Wah's stock price in the period. The North American business represents approximately 38% of total revenues and, more importantly, only around 18% of our appraisal value because the growth and margins in North America are much lower than Man Wah's domestic China business. In China, Man Wah dominates the recliner market with 38% market share, more than the next four players combined. Unlike in the U.S., where it is primarily a supplier to other brands, Man Wah owns the popular Cheers brand in China with strong pricing power and attractive margins. It is run by founder Wong Man Li, who owns over 60% of the company. He has led frequent share repurchases and bought shares personally in the open market in in the past year. We are excited to partner with a strong operator and capital allocator in Mr. Wong, as he continues to pivot the company towards the faster growing, more profitable domestic China market.

Healthscope (-9%), a leading private Hospital operator in Australia, was among the top detractors in the quarter. The company reported in-line sales growth, but missed street expectations for EBITDA growth in its fiscal year 2018 (FY18) first half results. Weakness in private hospitals, nurse wage inflation (especially in the state of Victoria), and one-off disruptions due to brownfield expansions at existing facilities were the key drivers for EBITDA contraction. However, these results were in line with management's expectations, and the company reaffirmed FY18 guidance. However, the share price pulled back because the market seems to question the company's ability to meet these projections. Management has embarked on a cost efficiency drive, which, combined with maturing brownfield sites, should enable Healthscope to deliver a meaningful pick up in EBITDA growth in the second half of the year. Management is exploring strategic options for its Asian pathology business, which could be sold at a value accretive price. Healthscope has a sizable non-earning asset in Northern Beaches Hospital, which remains on-time and on-budget and should start contributing to cash flows in FY19.

Speedcast (-6%), a leading global communications and IT service provider headquartered in Hong Kong and listed in Australia, was a detractor in the quarter, after being the top contributor in Q4 2017. FY17 results were in line with our expectations, with revenue up 136% and EBITDA up 195% (EBITDA margin up 500 basis points), driven primarily by acquisitions and return to moderate organic growth. The dividend doubled this year, driven by 95% EBITDA to operating cash flow conversion. Notably, the company correctly called the bottom in its Energy business (38% of total revenues), and management expects growth to return in this segment by the second half of 2018, which should generate high contribution margins. The Maritime segment (40% of total revenues) continues to post solid growth driven by customer migration from narrowband to broadband systems in the commercial shipping sector and increasing bandwidth requirement from cruise lines. Speedcast was successful in extending its contract with Royal Caribbean, and we await an announcement on its Carnival contract, which expires later this year. Enterprise & Emerging Markets (19% of total revenues) is expected to post significant growth in 2018, driven by the

National Broadband Network (NBN) contract win in Australia. Owner-operator CEO, PJ Beyllier, continues to focus on delivering organic growth in existing segments and value accretive M&A opportunities.

Vocus Group (-8%), a full service telecommunications operator providing fixed network services to Enterprise, Wholesale and Retail customers in Australia and New Zealand, which we initiated as a new position in the quarter, was a moderate detractor. Today, its market share is approximately 4% in Australia and 7% in New Zealand. Vocus went on an acquisition spree in 2015-2016, acquiring AMCOM (Western Australia focused enterprise and wholesale business), M2 (nationwide consumer business without network ownership economics), and Nextgen (one of Australia's largest nationwide fibre backhaul network). All of these acquisitions came with their own systems, processes, cultures and people. The company grew too fast, and integrating these acquisitions has been a challenge for the company, leading to multiple earnings downgrades and personnel turnover. The balance sheet is levered (by Australian standards) with net debt to EBITDA close to 3X. In addition, overall sentiment around the Australian telecom sector appears to be at its nadir, given the ongoing rollout of the NBN in the fixed space and imminent entry of a fourth network operator (TPG Telecom) in the mobile space. We believe that the impact of NBN and TPG Telecom on Vocus will be marginal because over 75% of the company's value comes from their Enterprise, Wholesale and Government businesses. We were able to buy this asset rich business with close to 30,000 kilometres of fibre network below its replacement cost, offering us a substantial margin of safety. Vocus is in the process of selling its New Zealand business, and upon completion, leverage would decrease meaningfully. Like-minded investor John Ho (Janchor Partners) built up a significant stake in the company and obtained a board seat. Execution has been the key challenge for Vocus over the last two years. We believe that the presence of Janchor on the board and the recent change in top management will accelerate the progress on this front and help Vocus maximize its underlying earnings power.

CK Hutchison (-5%), a conglomerate of global ports, health & beauty, infrastructure, energy and telecommunications, was also a detractor in the quarter. CK Hutchison reported strong results for 2017, with total revenue increasing 9%, EBITDA increasing 10% YOY and dividend per share increasing 6% YOY. The Telecommunications segment was the key value driver last year, with 3 Group Europe achieving 28% EBITDA growth. Italy stands out after the merger with Wind closed in November 2016, and attributable EBITDA in Italy doubled YOY in 2017. Ports delivered EBITDA growth of 8% with throughput increasing 4%. The Energy segment reported revenues up 48% and underlying EBITDA up 75% YOY, benefiting from higher oil prices and increased production. While the retail health and beauty operations (A. S. Watson) expanded store numbers by 6% as planned, segment EBITDA increased only by 2% with retail EBITDA from China down 6% in local currency. On the other hand, the retail store payback in China continues to be under ten months, and there are signs of promising improvements in the first two months of 2018. In March, Li Ka-shing announced his upcoming retirement after the AGM in May. We do not expect this change to affect operations and we are confident that Mr. Li's son Victor, who has worked with his father at the company for over 33 years and has been in control for over three years already, has already proven himself as a skilled capital allocator and aligned owner-operator, ready to lead the company going forward.

Portfolio Changes

During the quarter, we added one new investment, Vocus, discussed above, and exited Melco Resorts & Entertainment, as we moved our investment up to holding company, Melco International, to take advantage of the cheaper valuation and better alignment with Chairman Lawrence Ho's direct ownership in Melco International. We initiated three positions in the fourth quarter of 2017 that were undisclosed as of our last letter, namely AIN Holdings and Man Wah, both discussed earlier, and Inchcape. We added to these positions in the first quarter as they became more discounted.

Inchcape is a global automotive retailer and distributor incorporated in the United Kingdom (UK). It is undervalued because it is listed in the UK and trades in sympathy with the shrinking UK auto retailer industry, which has been negatively impacted by Brexit. In fact, the UK only accounts for 10% of Inchcape's operating profit, and the auto dealership business, which does 2% operating profit margins, only accounts for 20% of operating profits. Inchcape's historical roots are in Asia, where the company has large market share positions in Hong Kong, Singapore, and Australia. Emerging markets account for 86% of total operating profits, of which Asia generates the bulk of the profits and growth. Approximately 80% of operating profits are generated by the distribution business, which generates 8% operating profit margins and very high returns on capital. Inchcape trades at 11x free cash flow, and the cash is being intelligently allocated by CEO Stefan Bomhard towards value accretive M&A in the distribution space within emerging markets, as well as towards dividends and share buybacks.

Portfolio Outlook

Prospects of higher interest rates in the U.S. and parts of Asia are real, but we are confident that we have already risk-weighted our appraisal values for this scenario. In the face of historic low interest rates, we have stuck to the conservative discipline of using a 9% or higher (except in Japan, where we use 7% for domestically focused businesses) discount rate in our appraisals, and we seek to pay 60 cents on the dollar for new investments based on this conservative intrinsic value estimate. In a world where private market buyers are competing to pay less than 2% capitalization rates to acquire real estate buildings in gateway cities like Hong Kong, we use 5.5% or higher cap rates in our real estate appraisals. Our owner-operator managers are actively monetizing assets at these attractive valuations and buying back their own shares or paying dividends. The overwhelming majority of our investment holdings are either in a net cash position or carry low levels of debt. They stand ready to capitalize on any temporary market disruptions resulting from rising interest rates, thus potentially accelerating value growth. In a nutshell, we are confident that our company values remain relatively insulated from rising interest rates.

Despite the strong performance in recent years, Asia remains ripe with opportunities for a concentrated portfolio like ours to reallocate capital from businesses that have reached our appraisal into businesses that offer an attractive margin of safety. Our price-to-value remains in the low 70s%, and our cash balance remains low. Volatility in the last few weeks has created further pockets of cheapness, which we are in the process of evaluating.

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