Asia Pacific UCITS Fund Commentary 1Q19

Longleaf Partners Funds

For Professional Investors Only

For the quarter ending March 2019, the Longleaf Asia Pacific UCITS Fund was up 18.24%, outperforming the MSCI AC Asia Pacific Index, which was up 9.64%. In 2018, we meaningfully increased our exposure to Greater China by investing in businesses that had been hurt due to fears related to the U.S.-China trade war and a slowdown in the Chinese economy. These investments were the key drivers of returns in the first quarter.

Portfolio Returns at 31/03/19 – Net of Fees

	1Q19	1 Year	3 Year	Since Inception 2/12/2014
APAC UCITS (Class I USD)	18.24%	-7.13%	11.70%	7.75%
MSCI AC Asia Pacific Index	9.64%	-5.14%	10.03%	5.61%
Relative Returns	+8.60%	-1.99%	+1.67%	+2.14%

Selected Indices	1Q19	1 Year	3 Year
Hang Seng Index*	12.84%	0.03%	16.03%
TOPIX Index (JPY)*	7.55%	-5.38%	7.71%
TOPIX Index (USD)*	7.20%	-9.27%	8.26%
MSCI Emerging Markets*	9.91%	-7.41%	10.69%

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

Market Commentary

The first quarter marked a strong start to 2019 across most asset classes and regions, including Asian equities. The headlines that pressured equity prices globally in 2018 are turning favorable. Fears of U.S. interest rate hikes have abated, and the new consensus market expectation is for either no action or potential interest rate cuts. Asian currencies including the Chinese yuan have stabilized, oil prices are recovering and there is renewed optimism on the U.S. and China reaching a trade agreement.

The crackdown on the shadow banking sector that led to deleveraging in China is receding, and credit growth is returning. To stimulate the economy, Beijing is implementing supply side reforms, including cuts in the value-added tax and both consumer and corporate income taxes, rather than the traditional fiscal spending measures of the past. China's GDP growth is healthy, running at around 6% real and 9% nominal growth in 2018. China Manufacturing PMI is back in expansionary territory, and more importantly, consumption per capita continues to grow at about a 6% real rate. Overall, sentiment is favorable, quite a turnaround from where we were just 3 months ago.

Since we began the Asia Pacific strategy in 2014, we have seen three major waves of volatility in Asia, driven by sharply negative sentiment in 3Q 2015, 1Q 2016, and all of 2018. Each time, we took advantage of distressed prices offered by Mr. Market to upgrade our portfolio into even higher quality franchises with aligned capital allocators. It is helpful to recap what we did during bouts of extreme volatility in 2018:

1. Country allocations: Our country weighting is a function of bottom-up stock picking and not a target in and of itself. We rush towards fires to find opportunities where prices have been overly punished relative to value. China was one of the worst performing markets globally in 2018. Unsurprisingly, our weighting in China / Hong Kong increased from around 42% at the end of 2017 to over 60% by the end of 2018. This was largely funded by reducing our winners in Australia (from 17% to 7%) and Japan (from 19% to 16%). In addition, for the first time in our history, we initiated an investment in India (5%).

2. Businesses impacted by U.S.-China trade war fears: We initiated / increased our investment in businesses that were sold off on U.S.-China trade fears despite underlying economics being unaffected by tariffs. WH Group is the largest packaged pork manufacturer in the world, with over 80% of its value derived from selling branded packaged meats in China and in the U.S. WH Group is primarily a domestic Chinese business, yet its stock price dropped by approximately 45% from its peak to trough in 2018. Similarly, Man Wah, a furniture manufacturer that derives around 90% of its value from its branded domestic China business, dropped by around 60% from its 2018 peak to trough partly because of its wholesale exposure to the U.S., which is a low margin business and not a value growth driver. Chinese white goods manufacturer Midea, our first investment in the A-share market, was also hurt by China macro and trade war fears, allowing us to invest in this dominant brand at an attractive price. At the end of 2018, these investments accounted for around 12% of our portfolio.

3. Macau: China slowdown fears and U.S.-China trade wars impacted sentiment around Macau. Over 50% of visitors to Macau come from neighboring Guangdong province, which is the export hub of China. Both Melco International and MGM China saw about a 55% stock price drop from their 2018 peak to trough. The low margin VIP gaming revenue has indeed been negatively impacted by macro issues, but the higher margin mass business continues to grow, driven by infrastructure improvements in and around Macau. We increased our investment in Melco and initiated an investment in MGM China because of our confidence in the long-term growth of mass gaming in Macau. There are substantial non-earning assets at both companies that were not correctly valued by the market, and Mr. Market gave us an opportunity to buy these long-term compounders at single-digit normalized free cash flow (FCF) multiples. Beginning in 2019, Macau accounted for around 13.5% of our portfolio.

4. **Recycled ideas:** We invest in businesses and people that we know and understand. We like recycled ideas (businesses that we have owned previously) when we get to own them again with our desired margin of safety. In 2018, we re-invested in WH Group and Yum China when they became attractively priced again due to the China slowdown and U.S.-China trade war fears. In both cases, the businesses and their balance sheets were in better shape than the prior time that we owned them. These investments accounted for over 9% of our portfolio at the beginning of the year.

5. **Special Situations:** We increased our investment in Softbank and Speedcast during 2018 when they underwent significant selling pressure due to unique circumstances. Softbank suffered from fallout due to its association with Saudi Arabia, as the Saudi Public Investment Fund, which has committed $45 billion dollars, is the largest investor in the $98.6 billion Softbank Vision Fund. This, combined with its association with Huawei (which has been subject to U.S. government sanctions) and a perceived flop of its Japanese telecom IPO, led to about a 35% drop in its market capitalization in Q4 2018. In the case of Speedcast, a delay in energy recovery and one-offs led the company to revise its FY18 earnings downward. This, coupled with Australian investor perception (incorrect in our view) of excessive leverage at Speedcast, led to a drastic sell down of its shares from over 6.5 AUD/share in late August 2018 to less than 3 AUD/share by the end of 2018. Closing 2018, these two investments accounted for 9% of our portfolio.

As sentiment turned to the positive in the first quarter and our businesses delivered on expectations, the investments we made in the second half of 2018 recovered from oversold levels, as described in more detail below.

1Q19 Performance Review

	Contribution to Portfolio Return (%)	Total Return (%)
Top Five		
Softbank	+2.12	+46
WH Group	+1.73	+39
Man Wah	+1.66	+47
MGM China	+1.63	+25
CK Asset	+1.51	+21
Bottom Five		
First Pacific	-0.04	-6
Undisclosed	+0.04	+5
L'Occitane	+0.05	+2
Toyota Motor	+0.09	+0
Hitachi	+0.19	+8

TOP PERFORMERS:

Softbank (+46%), the Japan listed telecom and internet investment firm, was a top contributor for the quarter. The company reported a 62% increase in Q1-Q3 FY18 operating profit, driven by gains on its $98.6 billion dollar Vision Fund investments. As Softbank shareholders, we earn around a 1% management fee and a 20% performance fee (over an 8% hurdle rate) from this fund. Having listed its Japan telco business in 2018, Softbank is increasingly transforming itself into an investment holding company. Softbank's financial leverage improved meaningfully from 2.3 Trillion JPY in Softbank telco IPO proceeds and 3 Trillion JPY in a transfer of debt to the Japan telco subsidiary. On its fiscal 3Q earnings call, Masayoshi Son (Softbank's CEO and over 20% owner) made a compelling case on the extreme undervaluation of Softbank shares and announced a sizable 600 billion JPY buyback program. Softbank is the only company we are aware of in Japan, where management has detailed their views on the value of their company.
https://group.softbank/en/corp/irinfo/stock/stock_value/

Ride sharing company Uber is planning to IPO this year at a rumored valuation of over 100 billion dollars and Softbank (via Vision Fund) is the biggest owner with an over 16% stake in Uber. Despite the strong performance YTD, we believe Softbank continues to trade at around a 35% discount to our intrinsic value estimate.

WH Group (+39%), the world's largest packaged pork company, was a top contributor for a second consecutive quarter. We initiated our investment in 3Q 2018 when concerns around U.S.–China trade war and the spread of African Swine Fever (ASF) in China led to a sharp correction in its share price. The company reported results in line with expectations for 2018, driven by resilient performance in its downstream, branded, packaged meat business in both China and the U.S. The commodity-like upstream hog production and fresh pork business in the U.S. had a tough 2018 (and potentially even Q1 2019), due to oversupply of hogs and slaughtering capacity, but the outlook for the rest of 2019 is positive driven by demand from export markets. ASF has reduced sow (female pig) inventory in China by close to 20%, which would lead to higher prices for hogs in 2H 2019, but WH group will benefit from increased market share due to the ongoing consolidation in fresh pork market on food safety concerns. We trimmed our position as optimism on a potential U.S.–China trade deal led to sharp re-rating in WH shares.

Man Wah (+47%), the leading recliner sofa manufacturer in China, was a contributor in the quarter. Following the market sell off in 2018, during which the company bought back shares and management insiders bought shares at a steep discount, Man Wah's share price rebounded going into 2019. We visited its new Vietnam plant in January and saw that the production ramp up is on track. At the time of visit, the Vietnam plant was already exporting 600 containers of sofas a month, which could increase to 4,000 monthly containers over the next two years. Given its presence in Vietnam, any further increase in tariffs on China exports to the U.S. would work to Man Wah's advantage, as it could grab market share from OEM manufacturers who export from China. We are confident that founder and CEO Mr. Wong Man Li will increase the dividend payout ratio and restart share repurchases once the current capital expenditure cycle is over.

MGM China (+25%), one of the six Macau gaming concessionaires, was a top contributor for second consecutive quarter. Industry gross gaming revenue for Q1 2019 was down 0.5% YOY against a tough comparable of 21% growth in Q1 2018, but better than street expectations. More importantly, we believe the highly profitable mass gaming revenues grew high single digits while VIP revenues were down low double digits, driving EBITDA growth for the market. Improvement in infrastructure and hotel room supply are helping grow mass visitation to Macau. MGM China is gaining share as its newly completed Cotai resort is still in the early stages of ramping up. MGM's Cotai property EBITDA grew from around $17 million dollars in Q3 2018 to $60 million dollars in Q4, helped by growth in mass drop, VIP volume and better luck. These results, combined with optimism around a U.S.–China trade deal, credit growth, and strong A-share market performance, drove a re-rating in MGM China (and Melco) shares. Furthermore, MGM China's concession was extended two years to June 2022 – in line with the other concessionaire's term -- for a very reasonable $25 million dollar payment. This extension synchronized the bidding and renewal process for all six gambling concessionaires in Macau to align with the next term of the territory's government.

CK Asset (+21%), the Hong Kong and China real estate company, was a contributor in the quarter. CK Asset reported solid results for 2018, with dividend per share increasing 12% YOY and book value per share increasing 11% YOY. In 2018, CK Asset completed the sale of an office building, The Center, in Hong Kong at below 2.5% cap rate or 4,200 USD per square foot. The world's most expensive commercial real estate transaction was struck at over $5.1 billion dollars, about double our appraisal for this building. In the same year, the company deployed just half of the proceeds in UK commercial property to make up for the lost income after the Center was sold. Hotel portfolios saw profits increase 22% YOY, driven by an improvement in room rates and occupancy. Two more hotels will open in 2019, adding up to 15,000 rooms and serviced suites for the portfolios. Given the relatively high land price in HK, we expect that managing director Victor Li will continue to deploy the majority of the FCF into global projects at attractive returns.

BOTTOM PERFORMERS:

First Pacific (-6%) is a Hong Kong-listed investment holding company with its primary operations in the Philippines and Indonesia. We initiated our investment in Q3 2018. First Pacific's core assets include PLDT (the largest telecom operator in Philippines), Metro Pacific Investment Corporation (an infrastructure company with investments in energy, toll roads, water, and hospitals in the Philippines), and Indofood (the leading fast moving consumer goods company with exposure across consumer branded products, such as noodles, flour, agribusiness, and distribution in Indonesia). First Pacific's stock price has been under pressure due to weak 2018 results with a 4% decline in recurring profit, driven by weakness in PLDT and Indofood's earnings and unfavorable foreign exchange rates. Financial leverage at the holding company, coupled with broad weakness in emerging markets, further pressured the stock.

First Pacific is one of the most discounted Hong Kong conglomerates trading at a 60% discount to net asset value (NAV) (we took the liberty of copying their NAV per share calculation below). Additionally, the underlying listed assets themselves are undervalued in our view. On the recent earnings call, management reiterated their strategy to focus on core investments and dispose of non-core assets. The company recently announced an agreement to sell its 50% interest in food company Goodman Fielder for $275-325 million, which is expected to close in 2019. Disposal of non-core assets provide a brighter outlook on debt repayments, dividend payments and share buybacks, which should narrow the substantial NAV discount. The company has also completed a refinancing exercise to term out its debt repayment profile. First Pacific is run by CEO Manny Pangilinan, who owns 2% of the company and Chairman Anthoni Salim, an Indonesian businessman, who owns 44% of First Pacific.

Adjusted NAV per Share

FIRST PACIFIC

US$ millions	Basis	At 31 December 2018	At 31 December 2017
Indofood	(i)	**2,261.7**	2,474.2
PLDT	(i)	**1,182.0**	1,637.5
MPIC	(i)	**1,166.9**	1,814.1
Philex	(i)	**134.1**	276.9
PXP	(i)	**160.6**	88.6
FPW	(ii)	**325.0**	554.0
FPM Power	(iii)	**230.0**	230.0
FP Natural Resources	(iv)	**36.5**	58.5
Head Office - Other assets	(v)	**95.9**	100.9
- Net debt		**(1,550.2)**	(1,521.8)
Total Valuation		**4,042.5**	5,712.9
Number of Ordinary Shares in Issue (millions)		**4,342.0**	4,342.0
Value per share - U.S. dollars		**0.93**	1.32
- HK dollars		**7.26**	10.26
Company's closing share price (HK$)		**3.02**	5.30
Share price discount to HK$ value per share (%)		**58.4**	48.3

(i) Based on quoted share prices applied to the Group's economic interests.
(ii) Based on the total consideration (including US$25.0 million contingent instalment payment and another US$25.0 million earn-out payment) as per Share Purchase Agreement dated 11 March 2019.
(iii) Represents carrying amounts.
(iv) Based on quoted share price of RHI applied to the Group's economic interests.
(v) Represents the carrying amount of SMECI's notes.

L'Occitane International (+2%), the natural and organic based cosmetics company, was a relative detractor for the quarter. The company reported 4.4% like for like sales growth for 9MFY19, slightly below market expectations and slower than the 4.9% run rate in 1HFY19. U.S., Hong Kong and Japan exhibited slower momentum, but China continued to post double-digit sales growth, driven by online contribution (60% growth in Alibaba's 11-11 event). Management confirmed their full year operating margin forecast. L'Occitane announced the acquisition of British premium skincare brand Elemis for $900 million dollars, putting its net cash balance sheet to work. The headline multiples of 22.5X EBITDA is indeed very high, but management expects sales and EBITDA to grow over 30% in coming years. Elemis has significant growth opportunity in Asia, where it currently has minimal presence. The acquisition was funded with cash and low-cost debt.

Toyota Motor (+0%), one of the largest global automotive firms, was a relative detractor in the quarter. While the share price did not appreciate much compared to our other holdings, Toyota remains very attractive. Industrial net cash represents about half of its current market capitalization. As a result, the enterprise value of the company is merely about low single digits of its operating profits. This is very attractive for one of the top automotive companies in the world, as well as the front runner in electric and hybrid autos and technology. We have confidence in the leadership of Mr. Akio Toyoda, who understands the benefits of share repurchase. After completing its 300 billion share buyback program in August of last year, Toyota announced another 250 billion share buyback program in the quarter.

Portfolio Changes

During the quarter, our Japan weighting increased, as we added two new investments - Hitachi and an undisclosed investment. Midea Group, an undisclosed investment from Q4 2018 is also detailed below. We added meaningfully to our position in Baidu and Melco International. We trimmed WH Group and MGM International, and exited Vipshop and Yum China after strong YTD performance. We recycled the capital into more compelling opportunities.

We initiated an investment in Hitachi Limited, a Japanese conglomerate that has been undergoing significant restructuring and reform since the Global Financial Crisis. Ten years ago, Hitachi was a complicated and muddled group of businesses—a sprawling conglomerate that shocked corporate Japan with the size of its 795 billion yen loss in March 2009. Hitachi's current Chairman, Hiroaki Nakanishi, had retired from Hitachi Limited in 2006 and relocated to San Jose to run the struggling hard drive subsidiary, Hitachi Global Storage. Nakanishi returned to become a Representative Executive Officer at Hitachi Limited and became President in 2010, on the back of successfully turning around the Global Storage business.

Nakanishi, a western-educated (Stanford) leader focused on profitability and growth, has spearheaded a radical restructuring of a Japanese conglomerate. Chairman Nakanishi and his partner CEO Higashihara (who became CEO in 2016) exited low margin, unsustainable and volatile businesses. They sold the semiconductor business (now Renesas), sold the HDD business to Western Digital, joint ventured with Johnson Controls on air conditioners, spun off the LCD display business (now Japan Display), stopped TV production in 2012, and deconsolidated the power generation business by merging it with Mitsubishi Heavy. Ten years ago, the company had around 20 listed subsidiaries, now Hitachi has 4. We expect this number to shrink further. The transformation from a money-losing zombie corporation into a globally competitive conglomerate is not yet complete. Hitachi achieved double digit ROE last year and is on track to deliver 8% operating profit margins and 9% after tax OCF margins (including working capital changes) this year. They have ambitions to achieve over 10% operating profit margins in three years, led by current CEO Higashihara.

Hitachi has a governance system that stands head and shoulders above others in large-cap Japan. The board is majority independent, with 8 of 12 board members being independent, and highly qualified. Most importantly, this board is not a bunch of lightweights. They have real input and substantive oversight over strategy and capital allocation decisions. Of the 8 outside directors, 4 are non-Japanese, and all committees are chaired by external directors.

Hitachi trades at 3.3x EBITDA, 0.4X sales, 8x earnings and 8x FCF. Excluding the value of their four listed subsidiaries at market, the Hitachi stub, which accounts for 65% of the market cap of Hitachi Limited, trades at 0.2x sales and 2x EBITDA. The unlisted piece produces 12% EBITDA margins and 7% Free EBITDA margins.

Midea Group, a Chinese home consumer appliance giant, is a new investment we initiated in Q4 2018. Midea products portfolio ranges from air-conditioners, refrigerators, and washing machines to small home appliances. Market share of its products on average is about 25-30% and ranks among the top three in almost all the categories in which Midea competes. There is a secular trend for consumption upgrade in the industry that leads to healthy average selling price increases and margin expansions. However, in 2018, with the fears of a real estate slowdown and general macro weakness, coupled with ongoing China–U.S. trade conflicts, Midea's share price pulled back over 30%. While around 43% of Midea sales are overseas, only 5% of total exports are from China to the U.S. In addition, Midea has 18 production facilities overseas that can manage shipments flexibly, so the real impact of any tariff would be very limited.

Despite holding sizable net cash, Midea still manages to achieve above 20% ROE and is growing the business at high single digits to low double digits. We were able to buy this dominant franchise with enduring brands at a very attractive high single digit multiple of FCF. In July 2018, Midea launched a RMB 4 billion buyback program, which was one of the largest buybacks in the A-share market at that time to take advantage of the price discount. After we built our position in Midea, we were glad to see management complete the 4 billion buyback program swiftly and subsequently launch another RMB 6.6 billion buyback program. Founder He Xiangjian still owns 33% of Midea Group through Midea holdings, and CEO Paul Fang owns over $700 million dollars worth of stock. We are confident our owner managers will continue to create value for all shareholders.

Outlook

Despite the strong absolute returns YTD, we finished the quarter with our price-to-value (P/V) ratio at 65%. We have retained an attractive portfolio discount through trimming investments that approached fair value and redeploying assets into high quality, more discounted businesses. We run a concentrated portfolio of around 20 companies, and our hunting ground remains rich because of our broad universe, which includes all of Asia across the market capitalization spectrum. Even in buoyant markets, we are able to source compelling investments that meet our disciplined standards through the lens of Business, People, and Price. Our on-deck list of great companies we would like to own remains strong, and the upcoming elections in India, Indonesia, Australia and the Philippines could potentially offer up more opportunities.

During the first quarter we welcomed Taieun Moon as a junior analyst in our Singapore office. Taieun interned for us last year and joins us full time following his graduation from the University of Hong Kong. A Korean national, Taieun has also lived in Malaysia and Hong Kong. We look forward to his contributions to the team.

See the following pages for important disclosures.

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