Longleaf Partners Asia Pacific UCITS Fund Commentary

The Longleaf Partners Asia Pacific UCITS Fund returned 1.99% during the second quarter, exceeding the MSCI AC Asia Pacific Index, which returned 0.64%. The majority of our businesses made positive progress, as our management partners took smart actions to drive long-term value growth.

Double-digit returns at top performer CK Hutchison demonstrated how quickly share prices can respond to productive corporate activity. The combined CK Hutchison and Cheung Kong Property position increased by 47% during the quarter. This investment is highlighted below and serves as a template for other Asian conglomerates to unlock value under the leadership of second generation managements.

Iida Group Holdings, the largest builder of single detached homes in Japan, appreciated 29% during the quarter, reflecting an improvement in outlook for operating profit margins. The company successfully churned through high cost inventory and reduced working capital towards its target levels. From 2013 to 2014, Iida increased its already dominant market share position from 25% to 31%, compared to the next largest competitor with less than 2% share.

The two largest detractors to fund performance were Melco International and Lixil Group. Lixil declined 15% in the quarter after uncovering fraud at Joyou, a listed subsidiary of Grohe, which was acquired last year. Some of the losses from the fraud are recoverable through insurance, legal action and a tax write-off. The fraud at Joyou overshadowed the significant increase in free cash flow achieved by Lixil management, driven by cost cutting and large improvements in working capital.

Melco International (Melco) fell 8% with continued pressure on the Macau gaming industry, despite early signs of revenue stabilization in the last few months. In spite of industry challenges, Melco gained market share during the recently reported quarter and was quicker than peers in reducing costs. The new, mass market-oriented Studio City casino is on track to open by October and advances the government's efforts to broaden tourism beyond gaming. Studio City's approximately $2 billion of construction in progress (CIP) as of Q1 2015 is currently given zero value in Melco's stock price, even though the casino opens in less than three months. Excluding CIP, Melco is yielding 15% free cash flow to enterprise value, and over 85% of Melco Crown's EBITDA is driven by the non-VIP business, which we believe will grow at double-digit growth rates in the medium term. Melco's 34% stake in Melco Crown is worth over 170% of Melco's market cap as of July 8th.

CEO Lawrence Ho is a large owner and is building value by buying back deeply discounted shares, investing in high-return projects to increase visitor traffic, further shifting their mix towards higher margin mass and premium mass business, securing long-term credit lines to increase financial flexibility, and exploring ways to maximize returns on a limited supply of baccarat tables. We believe growth in the higher margin mass market will drive Macau gaming cash flow. New casinos with diverse non-gaming attractions and much-needed hotel room supply, as well as ongoing government investments in infrastructure, will facilitate more mass visitors. The reversal of the transit visa restriction announced on June 30 is the first sign of supportive regulatory policy to improve economic conditions in Macau. This should be positive for VIP and premium mass volumes.

An important part of our investment discipline is to consistently challenge and update our investment case and appraisal for each name. We assigned a "devil's advocate" (DA) to look at the business case for our Macau investments with fresh eyes and to test our assumptions. The DA undertook a quantitative analysis of the broad Macau gaming industry from a top down perspective. By combining household income and expenditure data with gaming behavior and statistics across activities and countries, he estimated the likely addressable Macau casino market and its potential growth. Detailed historical and recent gaming data from countries such as Australia provide reasonable estimates for levels of disposable household income required before casino gaming can be pursued as a leisure activity, and gaming spend as a proportion of disposable household income, i.e. a minimum of US$20,000 disposable household income is normally required before any gaming spend, after which 1.6% is spent on casino/slot gaming. Combining this with Chinese household income data and household income growth forecasts of 6%, the DA analysis concluded that Macau can grow revenues at double-digit rates driven by income growth and the arrival of "first-time" casino gamblers. With mass EBITDA margins 4x higher than VIP, EBITDA should grow faster than revenues as the mix of business shifts from VIP to mostly mass. Draconian assumptions of a significant slow-down in Chinese growth to 3% and a fall in mass EBITDA margins by a quarter would still provide single-digit EBITDA growth.

Our analysis disputes the speculation that the Macau gambling market may be permanently impaired as a result of the ongoing anti-corruption campaign. That thesis assumes the growth in Macau gaming has been driven by massive money laundering fueled by corruption. We believe, and data supports, that real demand for wagering comes more from increasing household disposable income

than money laundering. As shown in *Diagram 1* below, the regulated domestic Chinese lottery market, which is driven by the mass market, has shown consistent growth.

Although its performance has been disappointing, Melco remains our highest conviction holding, and we added to our position in the quarter.

Hong Kong Real Estate Review

During the quarter, a seminal corporate event took place in Asia. As detailed in *Diagram 2* (see next page), CK Hutchison merged with its 50% owned subsidiary, Hutchison Whampoa, and spun off Cheung Kong Property, the combined real estate business of Hutchison Whampoa and CK Hutchison. This corporate restructuring succeeded in reducing two persistent discounts applied by the market to CK Hutchison. First, the complexity of the corporate structure and diversified set of businesses within two layers of holding companies made valuing the company difficult. Second, market concerns related to a property exposure in Hong Kong and China have weighed heavily on the stock. CK Hutchison was the largest constituent of the Hang Seng Property Index, yet many property investors could not invest in CK Hutchison, given its significant non property businesses. This restructuring allows property investors to invest in a pure play property company – Cheung Kong Property – and moves CK Hutchison to its proper home in the Hang Seng Conglomerates Index.

The transaction removed much of the discount to NAV, and the combined shares traded after the spin off in early June at HK$196/share, compared to HK$125/share prior to the restructuring announcement in January. Victor Li, who took over day to day management of CK Hutchison from his father Li Ka-shing two years ago, drove this transaction. Victor is typical of the new generation of western educated scions taking over from the entrepreneur-founder generation in Asia. We believe that the CK Hutchison restructuring marks the beginning of a trend among Asian conglomerates to restructure and create shareholder value, driven by a new generation of younger, educated leaders taking over old line Asian family owned conglomerates.

We have a number of investments with exposure to Hong Kong property. These holdings include: Cheung Kong Property, Hopewell Holdings, Great Eagle, K. Wah, and our newest portfolio addition, New World Development. We are often asked, given sustained low interest rates and property price appreciation, if we are worried about a valuation bubble in Hong Kong property. We are keenly aware of the risks, and we do not believe the current two to three percent cap rates for physical property sales are sustainable in the long run. Public securities, however, are priced at more than double the cap rates implied in private (physical) market transactions. This offers a compelling opportunity for long-term investors who partner with savvy management teams focused on exploiting the arbitrage between public and private market valuations. Recent insider purchase transactions by real estate tycoons Li Ka-shing (Cheung Kong Property), Lee Shau Kee (Henderson Land), Lo Ka Shui (Great Eagle) and Robert Ng (Sino Land) illustrate this point.

The following bottom-up investment criteria underpin our case for our Hong Kong property investments. These are explored in more detail in the following Great Eagle and New World Development cases:

Diagram 1

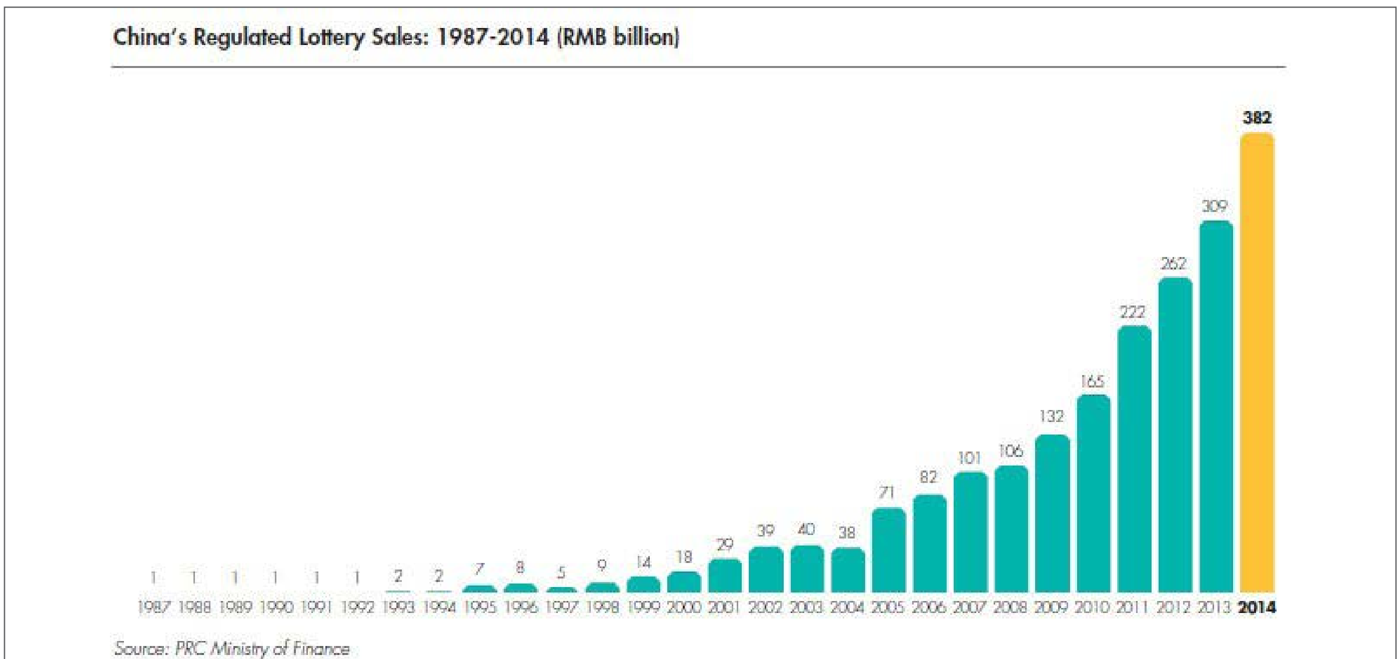
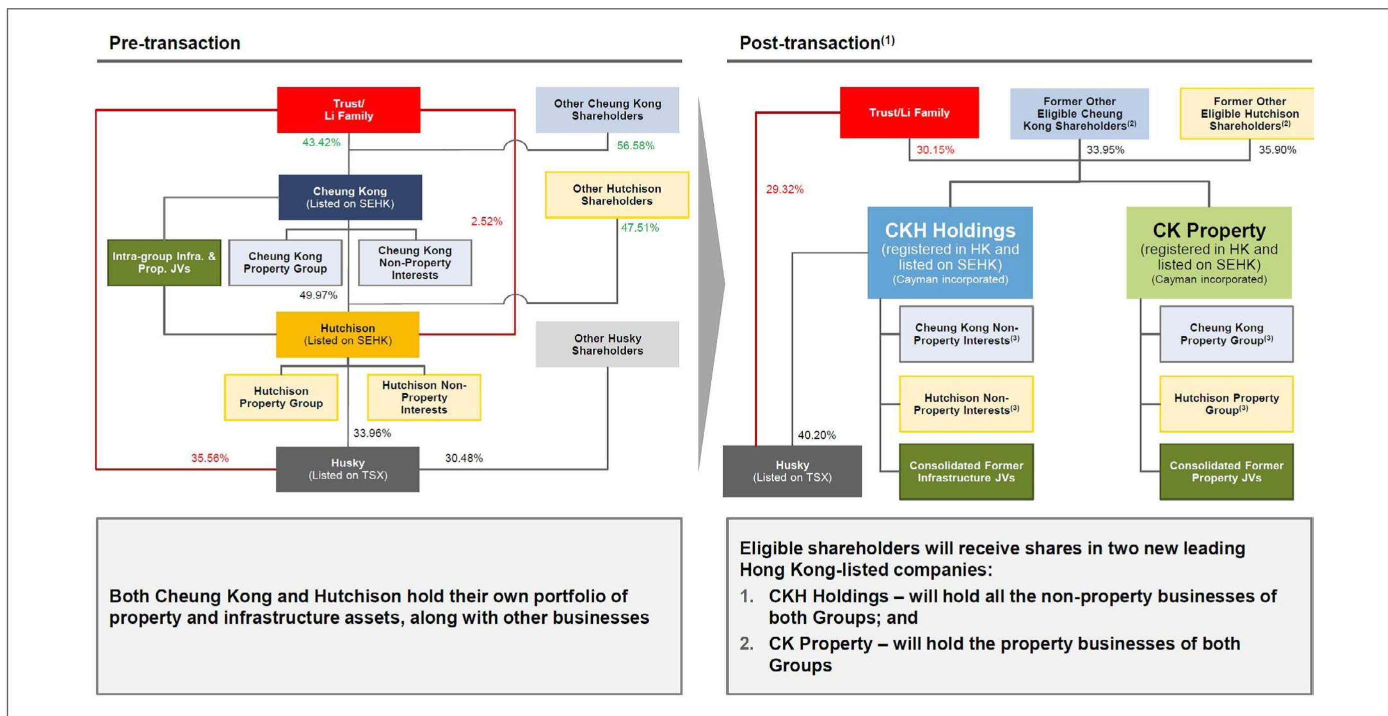


Diagram 2



- Significant discount to fair value: In many cases, through public markets, we are able to accumulate Hong Kong real estate assets at 30 -50% discounts to our NAV.

- People: We are partnered with experienced owner-operators who understand intrinsic value and allocate capital accordingly. Their actions indicate an ability to arbitrage the huge gap between private transaction values and low prices in the capital markets.

- Financial strength: We seek to invest in companies with clean balance sheets and the financial flexibility to exploit potential distress for the benefit of long-term investors.

- Long-term view: Our three-to-five year investment horizon allows us to take advantage of the market's short-term fears over a physical property bubble.

Great Eagle

Great Eagle is a prime example of the above investment characteristics. Chairman Lo Ka Shui (age 68), owns 55% of the company and has an impressive record of buying assets cheaply and monetizing them at a high price.

Until May 2014, Great Eagle had not acquired new land in a government tender in Hong Kong since 1989, when it acquired land one month after the crackdown in Beijing's Tiananmen Square. At the time, Great Eagle paid $300 million for land that has since become Hong Kong's Citibank Plaza; it was recently valued at $4.6 billion. Because the company has stuck to its strict pricing discipline, it lost every land sale auction it participated in over the subsequent 25 years. In May 2014, Great Eagle succeeded in winning at a HK land auction, purchasing land in Pak Shek Kok for HK$3,300 per square foot - less than half the price paid by peers in the same neighborhood. Before the Global Financial Crisis, Great Eagle sold most of its U.S. office portfolio at peak prices. Post crisis, they have re-entered the U.S. market, buying distressed hotel and office buildings at bargain prices. In May 2013, the company spun off its Hong Kong hotel properties into a REIT at HK$5/share (4% NOI cap rate / US$1.3mm/key), at a 36% premium to our carrying value and over 50% above the REIT's current price of HK$3.25/share.

The sum of Great Eagle's stakes in publicly listed Champion REIT and Langham Hotel Trust alone is almost equal to Great Eagle's current market cap. As investors in the stock, we get all of the hotels outside of Hong Kong, the U.S. and Hong Kong rental property, the management fee stream (from Champion REIT and Langham Trust) and the HK$3billion in cash for free. At the current price, Great Eagle is selling at 60% discount to our NAV. Lo Ka Shui has been personally buying shares in Great Eagle in recent weeks, underscoring his belief that the company is undervalued.

New World Development

Our latest investment, New World Development (NWD), is a

major Hong Kong conglomerate, founded by Cheng Yu Tung (CYT), who is 91 years old and retired. His son, Chairman Henry Cheng (68), and his grandson Adrian Cheng (35) now run the company. CYT handed over control of NWD to Henry in the 1990s. Adrian became CEO, Joint General Manager and Executive Director in 2012, but his power was cemented and the line of succession was set in stone this year with Adrian becoming Vice Chairman of NWD. This is another story of generational change under a western educated leader whom we believe will unlock the deep discount at which NWD currently trades.

Since 2012, Adrian has led the following smart actions:

- In May 2013, he tried to spin off the Hong Kong hotels into a REIT at a 5% yield, but failed due to negative market sentiment resulting from the U.S. Federal Reserve Chairman's tapering speech on 22 May 2013.
- In December 2013, NWD sold its stake in CSL, a Hong Kong mobile telecommunications operator, for HK$4.5 billion, or 9.5x EV/EBITDA, recognizing a net gain of HK$2.3 billion. Quoted from the press release: "The Board considers that the Proposed Disposal provides an opportunity for NWD to realize value for its shareholders in respect of its minority interest in a non-core asset."
- In March 2014, NWD tried to privatize New World China Land for HK$6.8/share versus HK$10.8 value. The take private deal failed due to a technical headcount rule specific to Cayman Island companies, but the attempted transaction highlights management's opportunistic thinking.
- In April 2015: NWD sold three hotels to a joint venture 50% owned by ADIA (Abu Dhabi Investment Authority) at a 3% cap rate, or HK$10mm/room.

Construction in Progress: NWD has a sizable non-earning asset in New World Centre, a 3.2 million square foot re-development project in Tsim Sha Tsui, Kowloon, Hong Kong. When completed in 2017, this could be worth more than 50% of NWD's current market cap. Mr. Market's short-term focus ignores this sizable construction in progress, giving long-term investors an opportunity to benefit from strong value growth in coming years. Today, NWD sells for over a 50% discount to our conservatively appraised NAV, offers over 4% dividend yield, and is led by a management team focused on monetizing assets to close the discount to NAV.

Outlook

We believe the Asia Pacific region remains the best risk return opportunity globally. In addition to the Hong Kong real estate pricing disparity between capital markets and physical markets, we continue to take advantage of the themes high-lighted in our last letter.

- China's anti-corruption campaign is hurting the performance of businesses with exposure to high end consumption, like luxury goods, gaming, retail and even consumer staples. As a result, we are starting to see more bargains emerge in good businesses with sustainable competitive advantage and pricing power.
- Value accretive domestic consolidation continues in fragmented markets in Asia. The latest example is the recent offer by our investee company, G8 Education, to purchase its next biggest competitor, Affinity Education at an attractive price.
- Supply-led weakness in commodity prices has caused sharp divergence between stock price and underlying value of mining servicers that we own. While the stock prices have shown high correlation with commodity prices, the underlying value of these businesses has in fact been resilient because they make money based on volume of production (and not price of commodity).
- Better capital allocation and improved corporate governance is evident in our Japanese investments and prospects. Our management partners are actively deploying capital to highest and best use including sensible M&A and buybacks.
- Smart capital allocation driven by generational change in management is well illustrated in the CK Hutchison and NWD cases described above. Cheung Kong restructuring is a great case study in closing the gap to NAV, and we believe this could potentially unleash similar restructurings in other conglomerates in the region.

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