Southeastern Asset Management, Inc.® | Advisor to Longleaf Partners Funds

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For Professional Investors Only

Asia Pacific UCITS Fund Management Discussion

The Asia Pacific UCITS Fund gained 1.46% for the first half of 2016, outperforming the MSCI AC Asia Pacific Index, which declined -1.00%. In the quarter ended June 2016, the fund declined -1.72% compared to a return of +0.70% for the index. Since quarter end, we have had a significant gain that brought the year-to-date (YTD) return through 15 July 2016 to 6.35% versus 2.74% for the index. During the quarter we took advantage of extremely low valuations in several Asian markets, including Hong Kong and Japan, to invest in strong businesses at significant discounts to value.

Portfolio Returns at 30/6/16 – Net of Fees

	YTD	2Q16	1 Year	Annualized Since Inception 2/12/14
APAC UCITS (Class I USD)	+1.46%	-1.72%	-5.07%	-1.66%
MSCI AC Asia Pacific Index	-1.00%	+0.70%	-9.63%	-2.75%
Relative Returns	**+2.46%**	**-2.42%**	**+4.56%**	**+1.09%**

Based on the relative valuations in global markets and the flight to safety we are seeing, **it is clear to us that today, actively managed Asian equities are among the most compelling investment opportunities globally.**

Consider the following market conditions:

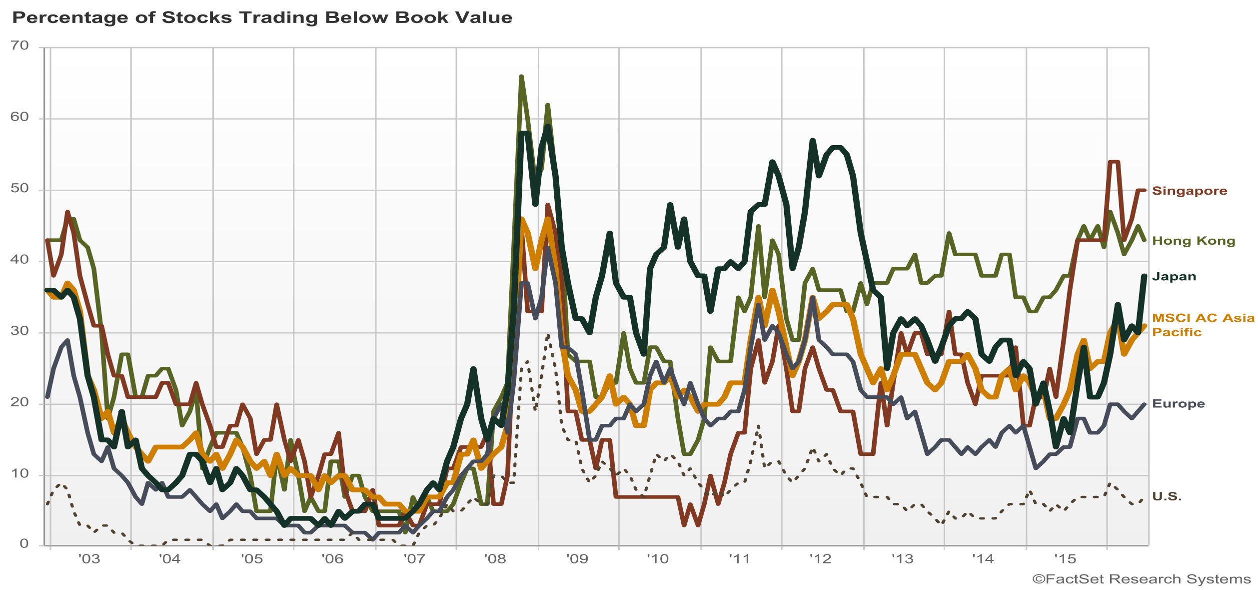
- Monetary policies and poor economic sentiment have led to historically low, and even negative, long-term sovereign bond yields.
- U.S. equity indices are hitting all-time highs with extraordinary premiums being paid for high yield, low volatility, "bond-like" equity securities.
- Real estate is transacting at historically low cap rates in most global gateway cities, aided by record low bond yields.

Against this expensiveness in many Western markets, consider the cheapness of equities in Asia:

- Nearly half the listed companies in Hong Kong, Singapore, and Japan trade below book value. (In the U.S., only 7% of listed companies trade below book, and in the U.K., only 12% of listed companies trade below book.)
- Hong Kong in particular stands out for its absolute and relative cheapness. The market is trading below book and almost **30% cheaper** than it did during the depth of the financial crisis in March 2009.
- The positive spread between Hong Kong dividend and bond yields stands at 125 basis points, a recent high; dividend yields are more than double bond yields.
- Over the last 12 months, Asia has been battered by fears over a China meltdown, currency devaluations, energy and commodity price collapses, emerging markets (EM) fund outflows, the threat of higher U.S. interest rates, the failure of Abenomics in Japan, and now Brexit, which should have little effect on Asian economies and the majority of companies in the region.

Illustrating this cheapness in Asian equities, the below chart shows how the percentage of stocks in Asia trading below book value has trended up this year, approaching levels seen during the Global Financial Crisis, while at the same time these ratios in the U.S. have declined.

Comparative Valuation Metrics (as of 30 June 2016)



Over the last year, worries centered on China macro fears have created what we believe to be a once in a blue moon opportunity to acquire high quality, large cap, rapidly growing companies that serve the Chinese consumer at a significant discount to intrinsic value. What gets lost in all the gloom and doom surrounding overcapacity, debt levels, and lower GDP growth in China is the strength in domestic consumption. Retail sales growth in China accelerated to 10.6% in June and consumption accounted for over 73% of first half 2016 GDP growth.

Amidst the panic, we acquired well-capitalized businesses linked to China consumption in companies such as Baidu, Global Logistic Properties, Vipshop, and L'Occitane. All these companies have dominant positions in their respective industries, with wide moats, and are led by owner-operators who took advantage of cheap valuations by repurchasing shares.

The cheapness of stocks in many Asian markets is not lost on company managements. We are seeing record levels of buybacks in several countries in Asia as managements take advantage of a historic opportunity to repurchase shares at extreme lows. The chart on the following page shows this phenomenon playing out in Hong Kong.

We are heavily overweight in Hong Kong given the deep disconnect between price and value, the quality of businesses listed there, and the heavy concentration of owner-managers who are highly incented to increase shareholder value. While commercial real estate trades at sub 4% cap rates in key cities globally, including Hong Kong, public property companies in Hong Kong trade at double-digit cap rates in the capital markets. The spread between cap rates implied in the stock price of property companies and cap rates at which physical properties transact has rarely been as wide as it is in Hong Kong. The portfolio owns Hong Kong investments that have dividend yields as much as five times higher than 10-year sovereign bond yields.

Source: Asia Insider

In our view, buying select real estate equities in Hong Kong is analogous to buying a deep-in-the-money convertible bond with a dividend yield of 3-5%, supported by a double-digit earnings before interest, taxes, depreciation and amortization (EBITDA) yield, and a strike price at 0.5 to 0.6 times net asset value. Having spent the last few days visiting U.K. property firms post-Brexit, even after a significant drop in share prices in the U.K. property space, valuations still compare poorly relative to the dividend yield and margin of safety that prevails in Hong Kong property stocks.

Another area of attractive opportunities is Japan, which has gone from one of the best performing markets over the past two years to one of the worst year-to-date. The positive market effects of Abenomics seem to have unwound, the yen has appreciated, and deflation threatens to return, resulting in drastic moves in share prices of some companies. Yet, capital allocation in Japan is improving rapidly, as evidenced by a record volume of share buybacks in Japan.

Our weighting in Japan went from 35% at the beginning of 2015 to 16% in the first quarter of 2016 as we allocated capital to better opportunities elsewhere in Asia, after many of our holdings in Japan increased in value and prices of Chinese equities dropped sharply. However, in the last quarter we have increased our allocations to Japan through investing our incremental dollars into two high quality Japanese companies we were able to purchase at discounts of more than 40% to our estimate of intrinsic value.

The price-to-value ratio of our portfolio is in the high-50s% and our cash level is low. We have personally contributed additional capital to the fund to take advantage of the historically cheap valuations in Asia. These are fantastic times for contrarian, long-term, fundamental investors and we are excited about the opportunities we are finding.

Portfolio Update:

SoftBank, Great Eagle, and K. Wah International were our top contributors in the second quarter, while results were negatively affected by weakness in Macau gaming through our investments in Melco International and Melco Crown Entertainment, coupled with downward revenue guidance at Baidu and the effect of Brexit on CK Hutchison. Our investments in Baidu and Melco remain among our largest positions, reflecting our conviction in these two companies and their management teams despite the recent price performance.

SoftBank (+19%) was our largest contributor in the quarter. In addition to the US$5 billion share repurchase announced in the first quarter, SoftBank raised US$18 billion dollars by selling a stake in Alibaba ($10 billion), Supercell ($7.7 billion), and GungHo ($0.7 billion) all at values close to or exceeding our estimates of their intrinsic values. Unexpectedly, Nikesh Arora, President of SoftBank, resigned, as founder Masayoshi Son deferred his previously planned retirement at age 60. Even more surprising was SoftBank's proposed acquisition of U.K. based ARM Holdings that was announced on 18 July 2016 for $31 billion, which translates to thirty-six times forward EBITDA and forty-four times earnings. These multiples are not cheap by any measure and if this were anyone else but Masa Son, who is the largest shareholder (19%) of SoftBank and who has a proven track record of 44% IRR return (twenty-five times) on investment, we would run for the hills. Even excluding Alibaba, Masa Son's investment track record has been strong. Their most recent exit of Supercell last month returned 93% IRR and their sale of GungHo achieved a 32% IRR. Nevertheless, it is always uncomfortable for us to buy into "paradigm shifts" as Masa Son describes his latest acquisition, and we are evaluating our investment in SoftBank. Masa Son's ability to see value where others don't has proven instrumental to his investment success.

Hong Kong listed developers **Great Eagle** (+20%) and **K. Wah** (+12%) were top contributors during the quarter, as sentiment towards Hong Kong listed real estate developers improved when fears over a rate hike dissipated and mortgage rates in Hong Kong drifted lower. Great Eagle announced a $2 per share special dividend, greatly increasing the dividend payout yield, and continued to monetize commercial real estate in San Francisco at sub 4% cap rates. K. Wah benefited from a significant increase in Chinese residential sales.

The global "risk-off" environment hit the Macau gaming sector hard this quarter. **Melco International** (-33%) and **Melco Crown** (-24%) were detractors as continued fear related to weak short-term results drove Macau gaming companies down. Melco had weaker performance than peers with disappointing early performance of Studio City, a new property that opened in Cotai in late 2015. Studio City's ramp up has been slower than expected, exacerbated by pedestrian access issues caused by casino construction adjacent to the property, scheduled to be completed in September, as well as construction of a light rail station behind the property. There is also fear of additional competition for City of Dreams (Melco's flagship gaming property in Macau) when neighboring Wynn Palace opens in August.

We believe that Macau gaming, particularly the more profitable mass gaming, is close to the inflection point where industry gaming volumes will begin to increase again, as evidenced by growth in overnight visitors from China which were up 7% in the past 6 months. Melco CEO Lawrence Ho said on the last quarterly earnings call, "We continue to see the operating environment stabilize in Macau, particularly in the mass market table game segment, which we believe expanded in the first quarter of 2016 when compared to the prior quarter. With the opening of Studio City in October, 2015, we have now further increased our exposure to the mass market segment, which we believe will be the long-term driver of profitability for our Company and the market as a whole." Reflecting his confidence in the future, Lawrence Ho continued to be active in buying shares personally.

Additionally, Melco Crown returned about $1.2 billion of cash to shareholders in the first five months of this year through dividends and a large buyback, repurchasing almost 10% of the company and highlighting its severe undervaluation. Put another way, Melco Crown will have paid out $2.14 per share in cash relative to the $12 share price, which is the equivalent to a <u>16% dividend yield</u>. With capital expenditures reducing after Studio City's completion and the balance sheet in a strong position, Melco Crown should see sizable growth in free cash flow in the coming years, and the company is returning this to shareholders in a value accretive way.

During the quarter, **Baidu** (-13%) lowered its second quarter guidance by 12% following issues that arose with its healthcare advertising segment. Government regulators issued new guidance on how online advertising should be vetted and presented on websites to clarify the difference between paid ads and search results. Baidu suspended sponsored healthcare ads pending regulatory review and adopted changes that limit paid results to 30% of each search page. While these changes will likely result in a negative short-term impact, we expect Baidu's online search business to continue to grow as it navigates an evolving consumer driven market. While the search business demonstrates a wide moat and stable source of cash flow, we expect the online travel agency business (through Baidu's stake in Ctrip.com) to grow even faster and the structural changes Baidu has made (written about in our 4Q 2015 letter) will result in a second wide-moat business that is compounding value rapidly.

With about 34% of EBITDA coming from the United Kingdom, **CK Hutchison's** (-14%) stock price fell, driven by fear related to Britain voting to leave the European Union. Despite 95% of its U.K. EBITDA coming from very stable infrastructure and telecom businesses, CK Hutchison's stock pulled back significantly more than any real value decline from Brexit and the devaluation of the pound. We took advantage of the price reaction and added further to CK Hutchison shares.

During the quarter, we initiated three new positions, exited one, and trimmed four. The bulk of our investments went into two Japanese companies, JIN Co. and Minebea. We exited Mineral Resources as the price rebounded over the past two quarters, and we trimmed G8 Education, WH Group and Hyundai MOBIS to fund our new purchases at lower price-to-value ratios. We are fully invested given the compelling opportunities we see across the region. We have started to re-allocate to opportunities in Japan as prices have become significantly more attractive and capital allocation has greatly improved, especially in small and mid-cap companies.

JIN Co. is the kind of Japanese company that gets us excited. It is the dominant Japanese player in a fragmented eyeglass industry and is led by 46% owner-founder Hitoshi Tanaka, who is taking share from smaller competitors and "mom and pop" shops that don't have scale compared to JIN. JIN has about 10% market share by revenues and about 28% share by volume in Japan. By selling 5.6 million pairs of glasses a year at an average price of roughly US$73 per pair, the company has an overwhelming scale advantage over competitors who sell much lower volume at an average price of US$220/pair. Privately held MEGANE TOP, with revenues of about $660 million last year (versus $410 million for JIN), sells only half the volume as JIN, with 2.8 million pairs per year at an average price of about US$200 per pair. Publicly listed competitor Paris Miki with about $380 million of eyeglass revenues, sells about 1.2 million units per year and has an average price/pair of US$300 and COGS per pair of US$100 per pair vs. JIN at $17per pair.

JIN's competitive advantage in scale allows it to make 74% gross margins on eyeglasses. Most of its production is overseas, and JIN benefits from a strengthening yen with dollar costs and yen revenues. In Japan, store level operating profit margin is about 33%, and new stores break even within 10 months (i.e. new store rollout is self-funding). The pipeline for growth in Japan is still long; management believes Japan store count can grow from 308 eyewear stores to 500 stores and $750 million of revenues, which will represent a share of approximately 20% of revenues and 45-50% of volume. It gives us further comfort that this target is achievable when we look at a comparable optical shop company in Germany, Fielmann, which has 21% revenue share and 52% volume share, driven by a similar low cost model with 586 stores operating in Germany with about 80mm people versus 127mm in Japan. Operating margins are currently depressed by heavy investments in new product launches as well as geographic expansion in China and the U.S., both which could become attractive markets in the future.

Minebea is a Japanese manufacturer of high precision equipment and components, such as ball bearings, motors, sensors (used in automobiles, aircrafts, home electronics, PCs, office automation equipment, etc.) and LCD backlight units (BLU) used in smartphones. Since mid-2015, the share price has declined over 60% because of concerns about the future of the BLU business, which in fiscal year ending March 2016 accounted for about 40% of sales but only about 20% of EBITDA and most importantly, only about 2% of our appraisal value.

The entire BLU sector is facing headwinds and could possibly be replaced by OLED in several years, although some industry players, including Minebea, argue otherwise. We have no information edge on the future of BLU, and its future destiny is not part of our investment thesis. Most of Minebea's value is driven by its machined components business, which has 25% operating income margins and is the company's cash cow. This segment includes the small ball bearings business (less than 22mm size), which has 60% global market share, and the pivot assembly business, which has 70% global market share.

Mr. Market pessimistically focuses on BLU and blindly values the whole company at 4.5 times EBITDA, 9 times price-earnings ratio and 1.1 times book. Even if we write down the entire BLU business now, Minebea's price looks compelling. Minebea is led by owner-CEO Yoshihisa Kainuma, whose family holds 7% of the company. During Kainuma's tenure as CEO, he has built out the backlight business, turned around the motor business, repurchased 5% of the company, and more than doubled book value per share since 2009. Just last month, he repurchased the equivalent of another 5% of Minebea by buying back convertible bonds at an attractive discount to our appraisal value of the company.

The past 12 months have been marked by high levels of volatility in Asia, and we've taken advantage of each major wave of volatility to improve the quality and attractiveness of the portfolio. The recent Brexit vote, subsequent movements in interest rates, and currencies have negatively impacted the share prices of a number of companies in Asia. We are busy evaluating these companies whose share prices have been whipsawed by these recent events to identify potential qualifying candidates for your portfolio.

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