Asia Pacific UCITS Fund Commentary

2Q18

Longleaf Partners Funds

For Professional Investors Only

For the quarter ending June 2018, the Asia Pacific UCITS Fund was down 5.7%, underperforming the MSCI AC Asia Pacific Index's 3.3% decline. Depreciation in the Japanese Yen and Australian Dollar, coupled with other adverse exchange rate movements, negatively impacted portfolio returns by over 2%, accounting for 40% of the pullback during the quarter. Additionally, companies with emerging market (EM) exposure were punished, as the MSCI Emerging Market Index fell almost 8% in the quarter.

Portfolio Returns at 30/06/18 – Net of Fees

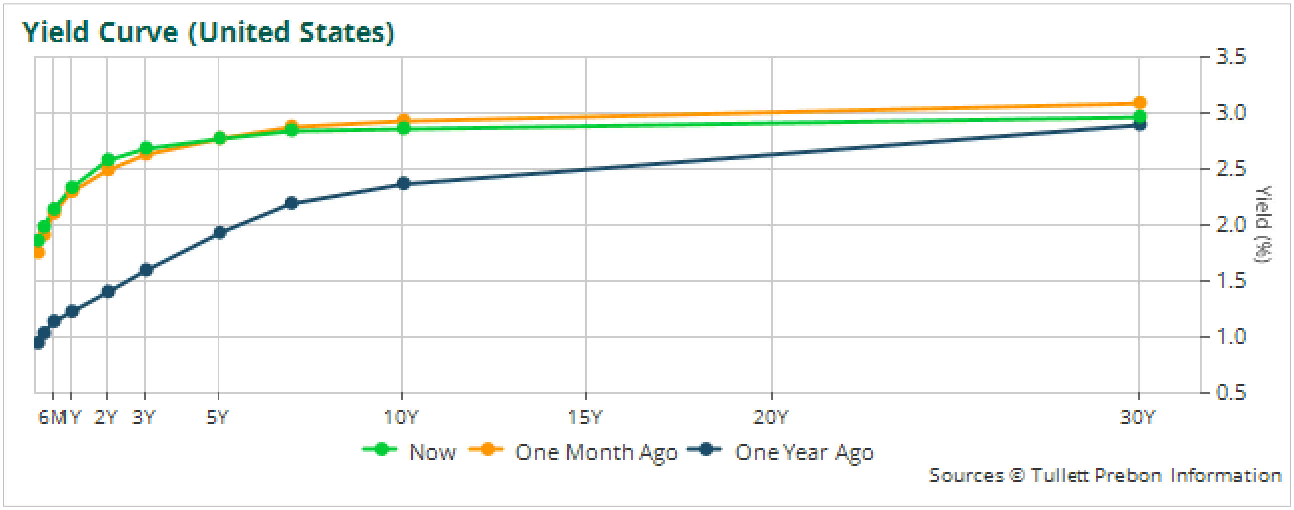
	2Q18	YTD	1 Year	2 Year	3 Year	Since Inception 2/12/2014
APAC UCITS (Class I USD)	-5.72%	-5.72%	6.70%	19.97%	10.97%	9.91%
MSCI AC Asia Pacific Index	-3.32%	-3.35%	9.93%	16.11%	6.81%	7.40%
Relative Returns	-2.40%	-2.37%	-3.23%	+3.86%	+4.16%	+2.51%

Selected Indices	2Q18	YTD	1 Year	2 Year	3 Year
Hang Seng Index*	-2.53%	-1.63%	16.29%	21.91%	7.01%
TOPIX Index (JPY)*	1.02%	-3.84%	9.31%	20.04%	3.86%
TOPIX Index (USD)*	-3.14%	-2.27%	10.86%	15.85%	7.29%
MSCI Emerging Markets*	-7.96%	-6.66%	8.20%	15.72%	5.60%

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

Market Commentary

This quarter was challenging for the Asian capital markets. Concerns about rising US interest rates, US dollar strength, EM debt weakness, and trade wars led to significantly heightened volatility. For the first time since 2007, the US yield curve is almost flat, with the spread between the 10- and 2-year US Government bonds at a very tight 29 basis points (as of 9 July), driven mostly by higher rates on the short end of the yield curve (see chart on following page). Higher interest rates on US short duration bonds have increased their relative attractiveness compared to equities, and in particular to EM bonds and EM equities. Higher fixed income yields have increased the cost of capital and have resulted in a de-rating of equities.



Source: Factset July 9, 2018

US monetary policy tightening has resulted in higher local real interest rates and weakening currencies broadly across EM, which negatively impacted our US dollar returns. In the last few weeks of June, we saw a 3.6% weakening in the renminbi, which contributed to the -9% return of the China Securities Index's CSI 300 in the quarter. Asia EM was particularly weak, with Pakistan, Indonesia, Malaysia, and the Philippines suffering double digit negative returns in the quarter. In stark contrast to previous years, the Information Technology (IT) Sector was the worst performing sector in the MSCI AC Asia Pacific index, costing the index -1.14%, or 35% of the loss in the quarter. Traditional tech stalwarts TSMC, Samsung, and Tencent were among the largest individual detractors in the index.

Last month, the Republic of Argentina issued one-year dual currency notes that pay investors the higher of 32.9% in Pesos and 4.5% in US dollars. The last time we saw such a move was during the Asian Financial Crisis (AFC) in 1997, when Korean issuers KEPCO and KDB issued dual currency bonds, as a rapid devaluation of the Korean Won created urgent liquidity needs. The issuance of one-year dual currency bonds is quite a dramatic reversal for Argentina, which issued a heavily over-subscribed 100-year bond just one year ago. For the first time in 17 years, Argentina had to borrow money from the International Monetary Fund in May. The Asian capital markets have not escaped this dramatic deterioration in sentiment towards EM.

Not only has Asia been a victim of the global tightening of liquidity, it has also been at the nexus of geo-political tensions and events at home and abroad. Malaysia just had its first democratic change in government, with the election of a fragile coalition led by 93-year old Dr. Mahathir, the strongman who famously pegged the Malaysian ringgit to the US dollar in 1998 at the height of the AFC. With the Trump-Kim summit in Singapore, we lived through weeks of Trump's "Art of the Deal" negotiating style, which we are seeing playing out in unpredictable trade wars between friends and foes of the US. More companies are being impacted by fears over a trade war, as the number of industries targeted for tariffs and trade war retaliation has increased. As a result, wholesale and indiscriminate risk reduction is happening, just like we saw in 1997-98 and again in 2015-16. Chinese companies in particular, even those with very little exposure to export markets, are being sold off aggressively. There are many valuable babies being thrown out with the bathwater today.

We are well-positioned to take advantage of resulting stock price volatility, as we did in the last downturn: by buying world class businesses whose intrinsic values are intact and compounding at an attractive pace, led by managers who allocate capital well, but whose market values are temporarily overly-depressed due to short-term macro worries.

Our opportunity set has increased significantly, and we are assessing a number of new companies, as well as prior investments that have become attractively priced again. As volatility remains elevated, we expect our turnover to increase, as we re-allocate capital towards the best risk-adjusted opportunities in today's environment. Given the increased opportunity set, we are re-assessing our current portfolio and have asked ourselves if there are any investments we would not add to further if prices drop another 20%. Those that we are not willing to increase, we have designated as our potential sources of capital. We exited some of these investments during the quarter to make capital available for more attractive opportunities. We are focusing our portfolio on our strongest, most capable corporate partners with compelling track records and long-term incentives.

A number of our portfolio companies have initiated buyback programs or have had significant insider buying in the past few weeks. Baidu, our largest investment in the Fund, initiated a billion dollar repurchase program at the end of June. Interestingly, they have repurchased shares only three times in the past - once in November 2008 during the global financial crisis and twice in 2015, when prices were severely depressed. Similarly, New World Development and Toyota Motor repurchased shares in the last quarter, reflecting their positive view on their companies. Additionally, the Li family personally purchased a significant amount of discounted shares in CK Asset at a substantial discount to our intrinsic value.

2Q18 Performance Review

	Contribution to Portfolio Return (%)	Total Return (%)
Top Five		
Healthscope	+0.82	+23
Speedcast	+0.75	+17
Baidu	+0.46	+ 9
Melco International	+0.37	+ 7
Inchcape	+0.29	+ 9
Bottom Five		
Vipshop	-1.91	-35
Pandora A/S	-1.39	-35
MinebeaMitsumi	-1.37	-20
Hyundai Mobis	-0.69	-15
L'Occitane International	-0.60	-11

Top Contributors

Healthscope (+23%), the second biggest private hospital operator in Australia, was the top contributor in the quarter, as it became the target of multiple bids by a private equity consortium led by BGH Capital and Brookfield Asset Management. We sold our position as the price exceeded our intrinsic value estimate. The Healthscope investment case highlighted a few themes that we have discussed in prior letters:

- Long-term orientation: Healthscope shares were deeply discounted when we initiated our investment in Q3 2017, due to multiple earnings downgrades caused by the near term headwinds relating to a decline in the private health insurance participation rate and coverage levels. However, we liked the long-term fundamentals of this industry, driven by aging population, longer life expectancy and higher incidence of treatable chronic diseases.
- Non-earning assets: Healthscope had spent close to 25% of its market cap in building new hospitals and expanding existing facilities – these investments were not generating any cash flow at that time.
- Sum of the parts: Healthscope has a significant real estate portfolio, as two-thirds of its hospital network is owned. We believe the real estate portfolio can be monetized at very attractive cap rates vs. our going in multiple. Amid the takeover bid, Northwest Healthcare REIT acquired 10% of Healthscope in pursuit of its property portfolio.

Speedcast (+17%), a leading global satellite communications and IT service provider headquartered in Hong Kong and listed in Australia, was a top contributor in the quarter. The company confirmed market expectations for FY 2018 EBITDA, implying over 20% growth year-over-year (yoy). Financial de-leveraging is on track, and the integration of Harris CapRock is going well. The company expects to exceed the original cost synergies target. Furthermore, Speedcast refinanced its existing debt facilities with a cheaper, covenant-light and longer tenure (7-year) US term loan B. The Libor + 2.5% price lowers interest cost by over 50 bps, a testament to the recurring cash flow generative nature of this business. Recovery in oil prices and continued growth in data consumption in the maritime sector (especially cruise ships) is positive for Speedcast.

Baidu (+9%), the dominant online search business in China, was a contributor in the quarter. First quarter results were strong, with revenue increasing 31% yoy, while Baidu Core (the core search and newsfeed business, excluding iQIYI), grew 26% yoy. Baidu continues to benefit from its strategy of focusing on its core business. In Q1, Baidu Core achieved non-GAAP operating margins of around 40%, compared to around 26% a year ago. In the second quarter, Baidu entered into definitive agreements to divest majority stakes in non-core businesses, including its financial services business and global advertising and tools business. The IPO of iQIYI (online video site) in late March was very successful and the current market capitalization is about 70% higher than its IPO price. Separately listing iQIYI alleviates content cost pressure, while highlighting the sum of the parts value of Baidu. iQIYI is being valued at around $22bn dollars, even though it is projected to incur about $900 million dollars in operating losses this year. At the current market price, Baidu Core is being valued at around 9.6x EBITDA and 14x free cash flow. We believe this is too low for a highly dominant and profitable business that is compounding at over 20% a year. Company management believes the core business will sustain high growth for a number of years, and they recently announced a US$1 billion share repurchase program to take advantage of the undervaluation.

Melco International (+7%), one of the six gaming concessionaires in Macau, was a top contributor in the quarter. Q2 started strong with April 2018 gaming revenue up 28% yoy for the overall market, but growth has moderated to 12-13% levels in May and June. These monthly numbers are quite volatile, depending on VIP win rates and special events, like the World Cup, but tend to move the market in the short-term. A slowdown in growth momentum, combined with China related fears, Union Pay payment processor terminal clampdowns, RMB devaluation and tight liquidity, has resulted in a sharp pullback in Macau stocks in the last couple of weeks, giving us an opportunity to add to Melco International and initiate another investment in Macau. We believe these are short-term disruptions, and the structural Chinese consumer driven growth story will sustain for years in Macau. Infrastructure improvements continue with HK-Zhuhai-Macau bridge construction complete and potentially opening later this year. Finally, Melco International opened its $1 billion dollar Morpheus hotel in June, which effectively doubles its flagship property's (City of Dreams) room capacity catering to premium mass customers.

UK listed automotive distributor Inchcape (+9%) was a contributor in the quarter with first quarter revenue up 6.2% in local currency, despite a challenging UK automotive retail market. The distribution business, which generates 8% operating margin and accounts for 81% of overall operating profit, grew 9.5% in local currency. Its distribution business was bolstered by the acquisition of a Suzuki distribution business in Central America in March at an attractive valuation. Inchcape, being listed in the UK, suffers from a Brexit discount and is misperceived as a low margin auto dealership business in a struggling retail environment, which typically does 2% operating profit margins. The company held a Capital Markets Day in June, where management highlighted the attractiveness of the profitable and growing global distribution business, clearly showing that the UK only contributes 10% of operating profits, while the growing Asia and Emerging Market regions contribute 80% of operating profits.

Top Detractors

Vipshop (-35%), a leading online discount retailer for brands in China, was the top detractor in the quarter. Total revenue in Q1 2018 increased 25% yoy, supported by strong revenue per customer growth. However, increased rebates and a reclassification of third party logistics costs into cost of goods sold resulted in gross profit margin compression. The market sentiment towards Vipshop was weak in the quarter because investors were disappointed to learn that the benefits arising from Tencent and JD.com's combined 12.5% investment in Vipshop in December at $13.08 did not result in immediate material benefits, even though the company is satisfied with the progress so far and has been actively working on further collaboration. We only built limited benefits from the collaboration into our appraisal, and Vipshop's high teens full year underlying organic growth expectation is in line with our forecast. In the second quarter of 2018, JD.com bought an additional 1.3% of Vipshop in the open market at $14.15, higher than its initial entry price, bringing JD's stake to 6.8% and underscoring Vipshop's attractiveness in the e-commerce industry. We believe that Vipshop is heavily discounted relative to our conservative appraisal, and we acquired more Vipshop shares during the quarter.

Pandora A/S (-35%), one of the world's largest mass-market jewellers, was another detractor for the quarter. Pandora reported first quarter results with 6% revenue growth in local currency and 33% EBITDA margin. While this set of results is below its full year guidance of 7-10% growth in local currency with 35% EBITDA margin, it is largely due to seasonality and was expected. The negative share price movement in the quarter arose from the negative surprise in its China operations. Growth in China decelerated to 16% yoy from 62% a quarter earlier, and same store sales were negative. Management attributed the slowdown to grey market trading into China and insufficient marketing spend. While Pandora has taken prompt measures to address these challenges and maintained its full year guidance, we have lowered our expectation for its Asia Pacific regions in our appraisal. Currently trading at just 7.5x earnings, we think that Pandora is undervalued relative to its profitability and growth prospects. We are following the company closely to assess its on-going development.

MinebeaMitsumi (-20%), the Japanese manufacturer of high precision equipment and components, was a detractor in the quarter. The company's conservative forecast for the financial year ending March 2019 was below market expectations. In May, it was rumored that Apple would adopt OLED screens for all iPhones next year. As MinebeaMitsumi provides LCD backlights for Apple, its share price was further impacted. However, this rumor is unverified and we believe unlikely to be true, given that MinebeaMitsumi recently decided to increase capital expenditures for the backlight business. More importantly, MinebeaMitsumi's entire backlight business only accounts for about 2% of our appraisal, making such a material share price movement unwarranted. Its cash cow, precision ball bearings business remains strong, with volume expected to be up 10% and revenue up 17% this fiscal year. Although optical devices and mechanical parts within Mitsumi will have a slow start in the first half of the year, demand is expected to increase in the second half, and MinebeaMitsumi has increased capacity by 50% for both sub-segments. Free cash flow generation continues to increase. Barring any major M&A, MinebeaMitsumi should be in a net cash position in two years.

Hyundai Mobis (-20%), auto parts maker and after-market parts provider for Hyundai Motor and Kia Motors, was also a detractor in the quarter. Both revenue and profits for the first quarter were below market expectations. While auto parts profits turned positive in the quarter, revenues still declined 14% yoy. The after-sales services business, on the other hand, remains healthy, with operating margins over 24%. A U.S.-based activist hedge fund invested in key affiliates of Hyundai Motor Group, including Hyundai Mobis, and opposed the restructuring plan the group proposed in March. As a result, the Hyundai Group cancelled the restructuring plan in May, and we expect them to announce an alternative restructuring plan later this year. At current market prices, we believe the attractive after sales services business and Hyundai Mobis' interests in other listed companies are insufficiently reflected in the share price, and any shareholder friendly restructuring plan could unlock value for Hyundai Mobis shareholders.

L'Occitane (-11%), the Hong Kong listed retailer of French natural cosmetics, was one of the top detractors for the quarter. The company reported FY18 results with sales down 0.3% yoy and operating profit down 16% yoy, largely in-line with our expectations. The key reason for underwhelming sales performance was currency impact. At constant exchange rates, sales grew over 4.5% yoy with the second half performing much better than the first half. Ongoing investments in marketing and emerging brands led to margin contraction in FY18 by around 200 bps, but we remain confident that this business with over 80% gross margin is capable of growing its current 10-11% operating profit margin to the mid-teens in the next few years. Margin accretive online sales are growing around 20% yoy and represent around 15% of total retail sales. The company's product pipeline is strong, and the balance sheet is net cash. We are encouraging the company to focus on profitability and increase dividend pay-out.

Portfolio Changes

During the quarter, we added two new investments. We initiated an investment in Indian cellular tower company, Bharti Infratel and another undisclosed investment in Hong Kong. As prices become more discounted, we also added to a number of our current portfolio holdings. We exited Healthscope, Automotive Holdings Group, Great Eagle, and Genting Berhad. We have concentrated our investments in companies where we have the highest conviction in valuation, cash flow and balance sheet strength, and the greatest confidence in management's skills.

As discussed above, we added an undisclosed Macau gaming company. Additionally, we made our first investment in India - Bharti Infratel, the dominant telecom tower infrastructure company with around 50% tenancy market share in India. Towers are attractive infrastructure assets that generate 70% EBITDA margins and roughly 60-65% EBITDA-maintenance capex margins. Contracts are typically 10-15 years long with built-in price escalators and pass through of energy charges. Scale begets scale due to multi-tenant discounting, which means rents get cheaper for everyone in the tower, as each incremental tenant joins a given tower. Due to the nature of the telecom market and regulations in India, operators have competed on price and not on service and network quality. Capex spending on network has not kept up with growing demand. Wireless broadband penetration in India is under 30%, and data usage per user is doubling quarter-on-quarter. Cellular networks are being deployed at higher frequency bands, which have lower propagation, thus requiring more tower sites (or smaller cells). So, why is it cheap? The key reason is the entry of Reliance Jio in the telecom operator space, which has disrupted an already competitive industry. Historically, over ten operators competed in 22 circles in India. With Jio's aggressive pricing, the mobile operator count is effectively coming down to 3 players - Airtel, Reliance Jio and the Vodafone-Idea merged entity. This ongoing telco consolidation will continue to cause tenancy exits for Bharti Infratel in the near term but should not have a meaningful impact on the company's value, given rapid data growth driving increased demand over the longer-term. We were able to buy this net cash company at around 12% EBITDA yield, while most of the developed and emerging market peers trade in the range of 5-8% yield. Our going in EBITDA yield is greater than a 50% premium to the 10-year Indian government bond yield.

The company's biggest customers – Airtel and Vodafone – are also the largest shareholders in Bharti Infratel. We believe there is a path to independence for Bharti Infratel where Airtel and Vodafone sell their stake in the company. According to Bharti Airtel's stock exchange disclosure of board meeting minutes, "The Board after due deliberations approved the proposal for merger of Indus Towers Ltd into Bharti Infratel Ltd. The Board decided to engage with the potential investors for evaluating a strategic stake sale post the completion of merger." KKR and Canada Pension Plan Investment Board own a combined 10% stake currently and have board representation and are natural buyers of the business. We get paid to wait for the consolidation to play out and growth to recover, receiving an almost 5% dividend yield today. At the same time, we believe that there is a reasonable likelihood of a change in control in the company.

Portfolio Outlook

Southeastern first invested in Asia during the AFC, when extreme volatility created significant opportunity to invest profitably in the region. Our International Fund was established in 1998 to take advantage of the opportunity set created by the AFC, coinciding with the opening of our first overseas office in Japan. We believe that the recent volatility in Asia provides a constructive environment for long-term opportunistic capital to set the stage for meaningful risk-adjusted returns.

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 ratio is now in the mid-to-high 60s%, 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.

Your portfolio managers have personally added capital to the Fund for the first time since Q1 2016, when emerging markets last reached their lows, reflecting our positive view on the opportunity set in Asia. We would not be surprised to see additional short-term panics and long-term opportunities present themselves.

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