

# Asia Pacific UCITS Fund Commentary 2Q19

For Professional Investors Only

For the quarter ending June 2019, the Longleaf Asia Pacific UCITS Fund was down 3.62%, while the MSCI AC Asia Pacific Index was up 0.83%. In the first six months of 2019, the Fund was up 13.96%, outperforming the index by 3.41%.

## Portfolio Returns at 30/06/19 – Net of Fees

	2Q19	YTD	1 Year	3 Year	Since Inception 2/12/2014
APAC UCITS (Class I USD)	-3.62%	13.96%	-5.06%	10.97%	6.45%
MSCI AC Asia Pacific Index	0.83%	10.55%	-1.08%	10.08%	5.48%
Relative Returns	-4.45%	+3.41%	-3.98%	+0.89%	+0.97%

Selected Indices	2Q19	YTD	1 Year	3 Year
Hang Seng Index*	-0.07%	12.76%	2.55%	15.08%
TOPIX Index (JPY)*	-2.42%	5.18%	-8.28%	9.98%
TOPIX Index (USD)*	0.19%	7.64%	-5.81%	8.36%
MSCI Emerging Markets*	0.61%	10.58%	1.21%	10.67%

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

## Market Commentary

This quarter, we saw significant volatility in Asia, caused by a spike in trade tensions between China and the United States in May, leading to further rounds of retaliatory economic sanctions and tariff increases. This caused significant volatility in Chinese equity markets and across Asia, when trade negotiations between the United States and China came to a stand-still, as China apparently walked away from a deal that was near closure. Given our overweight position in Greater China, we have experienced double digit changes in NAV in three of the past nine months, with minimal corresponding changes in the long-term intrinsic value of the businesses we own. All of the Fund's underperformance in the quarter can be attributed to our overweight positions in China and Hong Kong in a quarter when the MSCI China index was down 4%.

The U.S. threatened to raise import tariffs on the remaining \$300 billion worth of Chinese goods that have so far been spared from increased tariffs. Furthermore, the Trump administration placed restrictions on Huawei and other Chinese tech firms, barring them from purchasing vital components and software from U.S. companies, creating significant repercussions on the global

semiconductor supply chain. Semiconductors are one of China's top imports, and the industry depends heavily on U.S. technology and suppliers. When these developments were announced in May, the MSCI World index fell 5.7%, and the MSCI China index fell 13% in a single month. We also saw global risk-off moves causing volatility in Japan, as the strengthening Japanese yen saw a flight to safety rally, similar to that in U.S. treasuries, which resulted in a significant inversion of the U.S. yield curve.

During the last days of the quarter, we witnessed a relief rally, as the U.S. and China declared that they would re-commence trade negotiations and that U.S. companies would be able to sell some products to Huawei.

However, we suspect the U.S.-China tensions are far from over. Under a Trump administration, we can expect more trade-related volatility, whether in China, Mexico, Japan, Vietnam or potentially the European Union. The Chinese government and central bank have responded to the U.S. trade war by cutting interest rates and reserve requirements, reducing taxes, ramping up public spending and easing credit. China's stimulus measures, like the Fed's expected easing, probably means that the U.S.-China trade war will cause only limited damage to growth prospects in both countries. The Chinese government has many more tools to respond to macroeconomics shocks than the U.S. In addition to massive stimulus and currency depreciation, China's government can bail out private and public enterprises.

Additionally, the internet is becoming fragmented, as the U.S. and China increasingly create their own internet ecosystems protected by firewalls, their own online national champions, their own financial systems, and their own regulations. The new tech battle ground 5G, is potentially going to result in the creation of different systems of 5G development, as the U.S. withholds key technologies and components from Huawei – the Chinese 5G champion – as well as depriving them from markets in the West. The balkanization of the world economy will create volatility and new winners and losers. The U.S. multinational, which has been a large contributor to global growth in past decades may be severely affected by the new world order. We could continue to see new regions developing their own technology, supply chains, financial systems, reference bond and currency benchmarks, which could weaken the global position of the U.S. and create more interesting opportunities in Asia.

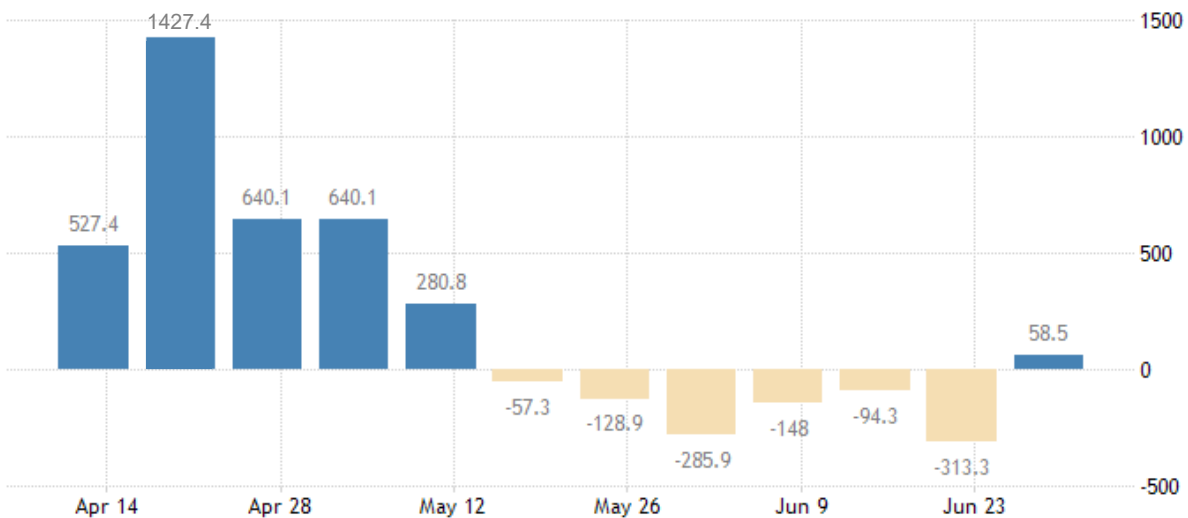
While we are bottom-up investors focused on individual companies, we do not ignore geo-political issues that can cause rifts in the macro environment where our companies operate. Conversely, we are seeing plenty of opportunity to take advantage of knee jerk reactions in the capital markets, where asset prices overshoot on the downside relative to the economic damage of macro events. This economic competition between the U.S. and China will result in significant volatility, as supply chains unravel, multinationals suffer, domestic champions emerge, regional capital markets develop, and reserve currencies and bond benchmarks change. For the long-term investor, who focuses on stock specific mispricing with very conservative assumptions, this provides opportunity to capitalize on investing in discounted assets.

### Portfolio Discussion:

Last year, the Fund's largest opportunity was in Chinese consumer discretionary companies, whose stock prices were severely affected by fears of a slowdown caused by higher import tariffs, and the reduction of liquidity in the financial markets. We took advantage of the fear in the capital markets and allocated our capital from relative winners (Japanese and Australian companies) towards the new opportunities – primarily in Hong Kong and China – which set the stage for strong performance in the first quarter of the year.

As our Chinese consumer companies rebounded, we began to recycle our capital out of China into more attractive opportunities elsewhere. For example, we sold Yum China in the first quarter – a little more than six months after we bought it for the second time in its short three-year history as a public company - as the share price rebounded strongly from its lows last year. We trimmed a number of our Chinese consumer investments, including WH Group and Man Wah, until May, when trade war tensions increased, and prices fell to the point where it made less sense to reduce our allocation.

### Foreign Stock Investment in Japan



SOURCE: TRADINGECONOMICS.COM | MINISTRY OF FINANCE, JAPAN

Just like in a restaurant whose menu constantly changes to reflect the best seasonal options, our menu of opportunities has changed often in the past year, as new and more attractive opportunities arose as storms of volatility hit various sectors and countries. This year, 100% of our new purchases have been in Japan. Our pipeline of potential Japanese investments continues to grow, as foreign selling of Japanese equities continued in 2019 and accelerated during the 2<sup>nd</sup> quarter (chart above), creating new opportunities. Japanese exposure to weakening China demand, especially in the large semi-conductor supply chain, as well as the strengthening yen and a slowing domestic retail industry compounded by fears over the upcoming consumption tax hike in October, have created selling pressure on Japanese stocks and thus an opportunity for us to purchase discounted assets.

On the other hand, dramatic changes in corporate governance and increased focus on capital allocation have created a more expansive menu of Japanese opportunities for us. After almost a decade of “Abenomics”, we are beginning to see some real corporate governance improvements in select companies with improved focus on returns. In the past, we have insisted on having an owner-manager - like Masa Son at Softbank, Yoshihisa Kainuma at MinebeaMitsumi and Akio Toyoda at Toyota - at the helm to gain confidence in capital allocation in Japan. However, two out of our three new investments in Japan are companies led by employee-managers. In both cases, the boards are majority independent with demonstrated influence on capital allocation decisions and an increased focus on returns.

Hitachi’s decision to cancel the £16 billion Horizon nuclear project in the United Kingdom, which would have incurred billions of losses had they continued, had heavy board involvement and oversight. Hitachi’s board is highly qualified and majority independent—eight of the twelve board members. Most importantly, this board is not a rubber stamp board. They have real input and substantive oversight regarding strategy and capital allocation decisions. Of the eight outside directors, four are non-Japanese, and all committees are chaired by external directors.

Ebara’s corporate governance system has improved dramatically in the last few years. In 2015, Ebara transitioned from a traditional Japanese board structure to that of a company with three committees (nomination, compensation and audit), and the board moved from minority independent to half the board becoming independent. Earlier this year, the board size was reduced to 11, of which 7 are outside independent directors. Two executive officers have stepped down from the board and the new Chairman, Sakon Uda, is an independent director (ex-McKinsey consultant). These changes are reflected in Ebara’s capital allocation and shareholder return policy. In its 107-year history, Ebara announced its first ever buyback in November 2018 and increased dividends by 33%. Ebara has repurchased 4% of the company just in the last 4 months. Crossholdings have been trimmed, and the company’s cash rich balance sheet is being deployed for shareholder returns. We discuss Ebara in greater detail later in the letter.

In Japan, we are seeing record levels of share buybacks, higher returns on equity, more successful activist campaigns and higher private equity involvement in industry. It is helpful that the Japanese government has significantly more skin in the game now than ever before, and we believe that has put tremendous pressure on Japanese companies to produce higher returns on capital. In 2009, the Japanese Government Pension Investment Fund (GPIF) held only 11.4 trillion yen of Japanese equities. Last December, GPIF held 36 trillion yen of Japanese equities, more than tripling its allocation to Japanese equities in the last decade. As Japanese bond yields disappeared and went negative, the pressure on pension funds to deliver positive returns for their aging population has forced them to decrease their exposure to fixed income, while increasing their allocation to equities. Today, the Bank of Japan owns roughly 5% of the Japanese stock market. All this has created real pressure on Japanese corporates to provide higher returns on invested capital for the benefit of all shareholders.

## Performance Review

2Q19			YTD 2019		
	Contribution to Portfolio Return (%)	Total Return (%)		Contribution to Portfolio Return (%)	Total Return (%)
<b>Top Five</b>			<b>Top Five</b>		
MinebeaMitsumi	+0.75	+14	SoftBank Group	+1.94	+44
Hitachi	+0.61	+14	WH Group	+1.72	+35
Hyundai Mobis	+0.51	+13	Midea Group	+1.21	+43
First Pacific	+0.39	+11	MinebeaMitsumi	+1.06	+18
L'Occitane	+0.35	+6	YUM China*	+1.05	+30
<b>Bottom Five</b>			<b>Bottom Five</b>		
Baidu	-1.96	-28	Baidu	-1.64	-26
MGM China	-1.29	-18	Ebara	-0.04	+2
Man Wah	-0.69	-25	Undisclosed	+0.01	0
CK Asset	-0.53	-10	CK Hutchison	+0.26	+6
Bharti Infratel	-0.45	-10	MGM China	+0.29	+2

\*Sold in 1Q19

### TOP PERFORMERS:

**MinebeaMitsumi (+14%, +0.75%)**, the Japanese manufacturer of precision equipment and components, was a top contributor for the quarter. This year is the tenth anniversary of Yoshihisa Kainuma's tenure as CEO. Over the last decade, he has compounded sales, operating profits, book value per share and EPS at an annual growth rate of 13%, 18%, 13% and 36%, respectively. This was achieved through a combination of organic growth, as well as 17 acquisitions, which were acquired cheaply and with negligible share dilution as a result of opportunistic share repurchases. MinebeaMitsumi acquired about 500 billion yen of revenues for only 58 billion yen in cash, and goodwill on their balance sheet is only 2% of equity, reflecting Kainuma's skill at acquiring companies, a competence that is rare in general, and particularly in Japan.

In May, Kainuma detailed his plan for the next ten years for MinebeaMitsumi to achieve 2.5 trillion yen in sales and 250 billion yen in operating profits, translating to 11% annual growth in sales and 13% growth in profits, through a combination of organic growth and M&A. For the next 3 years, 50% of the cumulative FCF will be allocated to share buybacks and dividends.

This year, MinebeaMitsumi's smartphone component and game device business will have a seasonally weak first half compared to the second half. In addition, ball bearings are seeing some weakness in data centers and fan motors. However, MinebeaMitsumi's competitive advantage remains strong, and the company is building up an optimal level of inventory to reduce expensive airfreight costs caused by rush demand from customers.

**Hitachi Limited (+14%, +0.61%)**, a Japanese industrial conglomerate, was a contributor in the quarter. For the fiscal year ended March 2019, Hitachi reported adjusted operating profit of 754.9 billion yen, which was slightly above the guidance of 750.0 billion yen, despite booking 30 billion additional reserves on overseas EPC (engineering, procurement and construction) projects. Hitachi announced its 2021 mid-term management plan in May, targeting at least 10% adjusted operating profit margins and a 3-year aggregate operating cash flow of 2.5 trillion yen, with more than 60% of sales from overseas and at least 10% return on invested capital (ROIC). This was the first time that Hitachi have included ROIC targets.

Hitachi also plans to invest 2-2.5 trillion yen over the next three years for growth. Recently, Hitachi announced that Hitachi Automotive Systems is acquiring Chassis Brakes, the sixth largest global brake maker for 80 billion yen. The headline multiple of 8x EBITDA does not look cheap, but the transaction should help Hitachi advance technological development and provide access to a new customer base. We believe there is ample upside with the company's focus on profitability in its core businesses, ability to generate free cash flow that will provide room for better shareholder returns and smart capital allocation and portfolio management through M&A and divestiture of businesses not earning a sufficient return on capital.

**Hyundai Mobis (+13%, +0.51%)**, auto parts maker and after-market parts provider for Hyundai Motor and Kia Motors, was a contributor in the quarter. Module and Parts revenue was up +7.4% YOY in the first quarter with solid growth coming from Electrification (+89.3% YOY) and core Parts (+22.8% YOY), despite Module sales posting negative growth of -3.1% due to the temporary shutdown of their Ohio factory. Module and Parts operating profit was still soft with continuing loss in China and margin drag from electrification. Their after-sales business was resilient with +3.7% YOY revenue growth and 25.1% operating profit margin, helped by favorable currency trends. Expectations are rising that the Hyundai Motor Group will resume restructuring its corporate structure. Given the opposition from shareholders on the previous restructuring plan, the revised one is likely to be more favorable to Mobis shareholders that could help unlock value. Though the stock has outperformed the market in the quarter, we believe the high quality after-sales business and Mobis's net cash and interests in various listed entities are still insufficiently reflected in the share price. The company announced that it would cancel 2 million shares, and execute a third of a 1 trillion Korean won share buyback plan in second half of 2019, in addition to initiating a quarterly dividend.

**First Pacific (+11%, +0.39%)** is the Hong Kong-listed investment holding company with its primary operations in the Philippines and Indonesia. Although the stock has outperformed the market, First Pacific is still one of the most discounted conglomerates listed in Hong Kong. During the quarter, First Pacific announced many positive corporate governance actions. The company announced the formation of a Finance Committee to be comprised of four independent non-executive directors and CEO Manny Pangilinan. Margaret Leung, an independent non-executive director, who we have met, will be the chairperson. In our view, the Finance Committee should meaningfully improve capital allocation decisions and address the over-leveraged balance sheet. Much of the discount

to NAV exists because of too much leverage and historically poor capital allocation decisions, which we identified early on as areas that could be improved to close the gap between price and our intrinsic value. The company also restructured the Corporate Governance committee to include only independent, non-executive directors. Furthermore, CEO Pangilinan's exit from the Remuneration Committee results in the committee being comprised of only non-executive directors, of whom the majority continues to be independent. First Pacific announced that they will search for additional new independent non-executive directors, which, in our opinion, should provide a fresh pair of eyes that can improve overall decision making. We are encouraged by First Pacific's efforts in improving corporate governance and capital allocation, and we believe there is meaningful opportunity within its core assets, as well as in its efforts on reducing the net asset value discount.

**L'Occitane International (+6%, +0.35%)**, the natural and organic based cosmetics company, was a contributor for the quarter. L'Occitane reported a respectable 1.8% same store sales growth in FY19 (ended March 2019) and more importantly, the underlying operating margin increased 80 basis points to 11.5%. Operating profit margin is expected to improve further in the current fiscal year. Our investment case in L'Occitane anchors on the company's ability to convert more of its gross margin dollars (GP margin of 83%) into higher operating profits. We are pleased to see management's focus on improving profitability by their disciplined marketing and advertising spend, and by eliminating excess costs.

This was a transformational year for L'Occitane as it made a sizable and seemingly expensive acquisition of Elemis, paying 22.5X trailing EBITDA. But, this is a high growth and high margin business, and it was funded by existing cash and very cheap debt, making the deal earnings accretive from the first year. Just 2% of Elemis sales come from Asia today, a region where L'Occitane has historically excelled. Asian expansion of the Elemis brand under L'Occitane ownership could deliver meaningful revenue synergies. We recently met Elemis CEO Sean Harrington and Managing Director Oriele Frank in London and understand why L'Occitane is excited about this UK-based skin care company. Sean has relocated to Hong Kong to launch Elemis in Asia, and we look forward to Elemis launching on Chinese online marketplaces and other Asian markets in the near future, with support from L'Occitane.

#### **BOTTOM PERFORMERS:**

**Baidu (-28%, -1.96%)**, the dominant online search business in China, was the largest detractor in the quarter and the first half. Baidu reported first quarter results in line with initial guidance, and Baidu's Core revenue grew 16% year-over-year (YOY). However, guidance for the second quarter was well below our expectation, driven mainly by macro weakness impacting advertisers' budgets and online advertising inventory increased across the industry, creating price pressure. In addition to these industry-wide headwinds, Baidu is migrating all the medical ad landing pages from third party sites onto Baidu's own servers. This initiative will further improve advertising quality and



Baidu's control over the content, but it will have a negative impact on ad sales in the short term. The share price declined sharply post first quarter results.

We remain confident in Baidu longer-term and believe the stock market has overreacted to its short-term challenges. The slowdown in ad sales is not specific to Baidu. Online players like Tencent, Weibo and the largest offline advertising company, Focus Media, have all seen a deceleration in ad revenues. While ad sales growth is not satisfactory at the moment, user traffic growth at Baidu has been strong and healthy, which provides the basis for future monetization. In March, Baidu App's daily active users (DAUs) grew 28% YOY, and Baidu Smart Mini Program's monthly active users (MAUs) saw 23% sequential growth. There was some concern that growth would fall off post the Chinese New Year promotion, but the latest data indicates otherwise. Encouragingly, in June, Baidu App DAUs increased 27% YOY, and Smart Mini Program MAUs increased 49% quarter-over-quarter.

At the current share price, Baidu Core advertising is trading at less than 1 times sales and 3 times 2018 free cash flow. In addition, Baidu is making steady progress in AI initiatives, which are not reflected in the current market valuation. For example, Baidu's voice-activated smart speaker became number one in China and number three globally measured by shipments in the first quarter of 2019. Also, Baidu's Apollo autonomous driving effort registered nearly 140,000 kilometers in Beijing last year, representing about 91 percent of total self-driving distances traveled by the eight licensed transportation companies in the city. The current trade tension between China and the U.S. doesn't impact Baidu directly, as almost all of its sales are domestic. However, it does significantly reduce Google's ability to re-establish a meaningful presence in China, strengthening Baidu's already dominant position in the Chinese search market.

We support Baidu's decision to launch an additional \$1 billion (USD) share buyback program, on top of the existing remaining \$500 million program to take advantage of the current low share price. Paying low-single-digit FCF for a strong cash generative and hard-to-replace asset should provide attractive returns over time, and we have added to our investment in Baidu.

During the 2019 Baidu Create Conference in July, someone walked onto the stage and poured a bottle of water on CEO Robin Li while he was speaking. We feel sorry for Robin, but it reminded us of the incident in 1998 when Bill Gates had a pie thrown in his face. Microsoft's share price went up almost three-fold in the following two years. We believe and hope that this incident also marks a low in Baidu's share price.

**MGM China (-18%, -1.29%)**, one of the six Macau gaming concessionaires, was a detractor for the quarter. The company reported better than expected Q1 results with industry leading EBITDA growth of 27% YOY. MGM China gained market share in both mass and VIP segments, as its newly opened Cotai resort continued to ramp up. Yet, MGM's shares were down, along with all its peers, as trade tensions between the U.S. and China resurfaced during the quarter, and industry gross gaming revenue (GGR) for Q2 2019 was down around 0.5% YOY against a tough comparable of 17% growth in Q2 2019. Mass gaming grew by over 10% in Q2, while VIP continued to decline at a



mid-teens rate. Arguably, the pace of MGM's Cotai ramp up has been slower than we expected, but now with VIP junket rooms and 20 out of 27 mansions (catering to premium mass and VIP customers) open, we expect the company to continue gaining market share and delivering best in class luck-adjusted EBITDA growth this year.

**Man Wah (-25%, -0.69%)**, the leading recliner and sofa manufacturer in China, was a detractor for the quarter after being a strong contributor in the first quarter. The trade conflict escalation between the U.S. and China in the quarter is hurting sentiment towards exporters like Man Wah. However, Man Wah is well ahead of its peers in establishing production capacity outside of China. As of June, its plant in Southeast Asia is already contributing about 40% of total Man Wah's exports to the U.S. and by mid-next year, Man Wah could transfer all of its U.S. export business away from China. The more important branded domestic business, which contributes more than 60% of its profits, is progressing on track with management expectations, and the competitive landscape is turning healthier compared to last year. Overall, the total company's sofa volumes continue to increase year after year. In 2018, Man Wah became the world's number one motion furniture company by selling over one million sofas.

**CK Asset (-10%, -0.53%)**, the Hong Kong-based real estate and infrastructure company, was a detractor in the quarter. Contrary to widespread expectation that trade wars and protests in Hong Kong would have a negative impact on local property market, the Hong Kong primary residential market has seen the highest transaction volume in the first half of 2019, compared to the same period over the past 5 years. Given that land acquisition prices remain relatively high, CK Asset continues to look for global opportunities with the aim to replace real estate development profits with recurring income. We appreciate CK Asset's strict capital allocation discipline in project selection and financial strength. We are confident that Managing Director Victor Li will be able to compound value for shareholders over time.

**Bharti Infratel (-10%, -0.45%)**, the dominant telecom tower operator in India, was a detractor for the quarter. The company reported weaker than expected results. After two quarters of stable tenancies on its towers, Infratel reported a net churn in collocations for the last quarter. This was due to incremental exits from Vodafone-Idea as they continue to rationalize their network footprint and exit some marginal markets, post-merger. We believe that we are in the final stages of tenancy decline and expect growth to return, possibly within the next two quarters. In the meantime, the merger process with Indus towers is proceeding as expected. We are awaiting approval from the Department of Telecommunications as the last step. Post-merger, we expect Infratel to execute value accretive repurchases of its own shares and to increase dividends per share.

## Portfolio Changes

In the past six months, we initiated an investment in Ebara, Hitachi, and in a Japanese retailer, which remains undisclosed.

Ebara is a Japan-based industrial manufacturer operating in three segments:

- Fluid Machinery and Systems (FMS): Key products include standard pumps, custom-made pumps and large-scale compressors. Ebara has around 35-40% market share in Japan in pumps for buildings and public infrastructure (around 7% share globally). Ebara's Elliott branded compressor business has number one market share (around 20%) globally in downstream oil & gas applications (refining, petrochemicals, LNG).
- Precision Machinery (PM): Ebara supplies chemical-mechanical planarization (CMP) systems to make silicon wafers perfectly flat and dry vacuum pumps and components to semiconductor manufacturers. CMP is a duopoly market with Ebara having 30% market share behind market leader Applied Materials.
- Environmental Engineering: Ebara handles design, construction, maintenance and operations of waste incineration plants and other waste treatment facilities in Japan. Over 75% of operating profit derives from operations and maintenance revenue stream.

Ebara margins are currently at trough levels. The FMS segment reported 2.8% operating income margins in 2018, well below the company's medium-term target of 8.5%. 2018 margins were impacted by a downturn in the oil and gas market, aggressive pricing by some competitors and other one-off factors. Management is focused on reducing fixed costs and increasing the ratio of service and support revenues, which generate much higher margins than sale of new products. Another reason for cheapness is the outlook for the PM segment, which is exposed to the semiconductor capex cycle. As discussed above, the U.S.-China trade war and restrictions on Huawei have hurt investor sentiment around suppliers to the semiconductor industry.

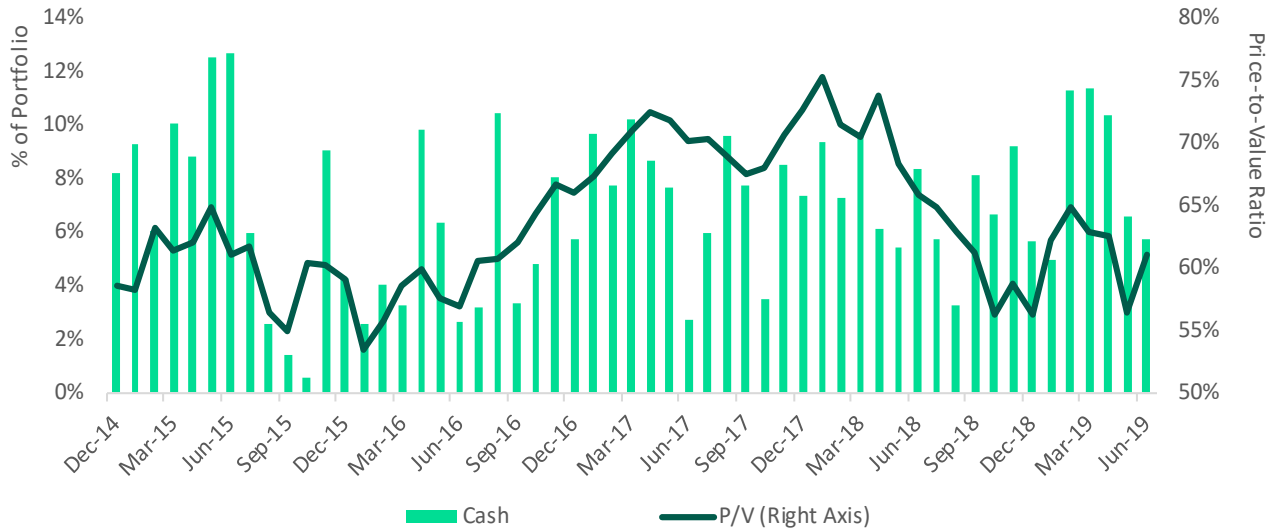
Ebara trades at almost half the EBITDA multiples (on trough margins) of its peers (Sulzer, Xylem and Flowserve for FMS segment, and Applied Materials and Pfeiffer Vacuum for the PM segment). This level of discount is unwarranted, especially given the strength of Ebara's balance sheet (over 20% of market capitalization is in cash and financial investments) and the company's newfound focus on improving ROE and shareholder returns (as discussed earlier in this letter).

## Outlook

Volatility continues to offer us the opportunity to buy high quality businesses at discounted prices. Our on-deck list is robust, and we are almost fully invested. Some markets that have historically been too expensive for us (emerging Asia) are starting to drift towards our desired price range. Our Price-to-Value ratio ended the quarter at 61% and the cash level was 5.7%.

## Monthly Price-to-Value Ratio and Cash Levels

Dec 2014 - Jun 2019



Your fund managers have personally put more capital into the Fund to take advantage of the attractive margin of safety and positive outlook for the businesses we own. A number of our management partners at our portfolio companies are also taking advantage of the deeply discounted asset environment to opportunistically repurchase shares, acquire listed subsidiaries, and acquire other companies.

*See the following pages for important disclosures.*

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