Asia Pacific UCITS Fund Commentary 4Q18

Longleaf Partners Funds

For Professional Investors Only

The MSCI AC Asia Pacific index was down 13.52% for the year and down 10.96% in the fourth quarter. The Fund underperformed the index in both periods. More than 80% of the underperformance for the year was driven by our overweight in Consumer Discretionary, one of the worst performing sectors in 2018. Further, if we look through a geographic lens, our overweight position in Greater China accounted for approximately 70% of the underperformance for the year. We increased our weighting to these two most hated areas too early in the downturn.

Portfolio Returns at 31/12/18 – Net of Fees

	4Q18	1 Year	3 Year	Since Inception 2/12/2014
APAC UCITS (Class I USD)	-12.05%	-21.45%	6.76%	3.88%
MSCI AC Asia Pacific Index	-10.96%	-13.52%	6.10%	3.59%
Relative Returns	-1.09%	-7.93%	+0.66%	+0.19%

Selected Indices	4Q18	1 Year	3 Year
Hang Seng Index*	-6.73%	-10.54%	9.64%
TOPIX Index (JPY)*	-17.63%	-16.26%	0.67%
TOPIX Index (USD)*	-15.33%	-14.61%	3.68%
MSCI Emerging Markets*	-7.47%	-14.58%	8.90%

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

Market Commentary

2018 marked a year of widespread market declines, hurting investors across many asset classes, inclusive of public equities. As the year progressed, trade wars, U.S. interest rate increases, U.S. dollar strength, geopolitical unrest, fears of economic slowdowns in multiple countries, including China, and falling oil prices were among the primary headlines pressuring equity prices around the world.

Most equity, credit, and commodity asset classes took a synchronized dive during the fourth quarter, with the exception of government bonds, and certain currencies, such as the Japanese yen, which benefitted from a global flight to safety. The tech darlings, Facebook, Apple, Alphabet, Alibaba, TSMC, and Tencent all fell during the year. The downdraft was widespread across Asia, where the only sector that enjoyed positive returns was the MSCI Asia Pacific Utilities index, with its bond-like characteristics.

A year ago we posed the question: Why had our approach been successful? Reflecting on 2018's performance, we asked ourselves: Where had we gone wrong? 2018 results do not reflect the progress within our portfolio, where we repositioned into more heavily discounted and/or qualitatively attractive opportunities over the course of the year. We exited ten investments in 2018, redeployed capital into seven new investments, and added further capital to thirteen existing investments. We shifted our portfolio to the most attractive investments from a risk-adjusted return basis and increased our exposure to cheap Chinese consumer names that have been severely impacted in the capital markets yet continue to compound value. Two of the new investments are "recycled" businesses that we previously owned in the last down cycle. We believe these new investments add to the foundation for future compounding and that the market has taken a short-term view, heavily discounting these world-class businesses managed by smart capital allocators. As long-term investors, one of our key competitive advantages is time arbitrage, which allows us to act on our contrarian view, enabling alpha opportunities.

We also made some mistakes. In the fourth quarter, for example, we bought and sold Brilliance China (Brilliance) shortly after purchasing a small position. In Brilliance, we identified a cheap and growing company but overlooked the management's lack of control over capital allocation with government involvement, which yielded poor results for shareholders. We took our medicine, learned our lesson, and moved onto more compelling long-term investment opportunities.

Performance Review

4Q18	Contribution to Portfolio Return (%)	Total Return (%)
Top Five		
WH Group	+0.41	+10
MGM China	+0.30	+6
Melco Int'l	+0.24	+2
Bharti Infratel	+0.21	+5
L'Occitane	+0.15	+3
Bottom Five		
Baidu	-2.21	-31
Softbank	-2.02	-35
Speedcast	-1.59	-29
MinebeaMitsumi	-1.41	-20
Brilliance China	-1.34	-42

2018	Contribution to Portfolio Return (%)	Total Return (%)
Top Five		
Vocus	+0.93	+20
AIN Holdings	+0.79	+33
Healthscope	+0.39	+12
YUM China	+0.20	+4
L'Occitane	+0.03	+1
Bottom Five		
Man Wah	-2.60	-56
Vipshop	-2.41	-53
Speedcast	-2.32	-44
Baidu	-2.18	-31
MinebeaMitsumi	-2.06	-30

WH Group (+10%), the largest global packaged pork producer, was a top contributor for the quarter. This is our second time owning this consumer franchise. We invested following a sharp correction in its share price due to concerns surrounding U.S.–China and U.S.–Mexico trade war and African Swine Fever (ASF) in China. An overwhelming majority of WH Group's intrinsic value derives from its dominant branded packaged meat business in China and the U.S., which is a domestic business that is not impacted by U.S.–China trade war. While there could be small impact on near-term earnings from ASF, we believe WH group stands to benefit in the medium term, as these conditions would squeeze out marginal players and lead to consolidation in the highly fragmented Chinese pork market.

Macau casino operators—MGM China (+6%) and Melco International (+2%)—were among the top contributors in the fourth quarter, as fears over a significant deceleration in gross gaming revenue (GGR) eased. Industry GGR declined from the 17.5% August YTD run rate to around 3% in September and October, caused by bad weather, as well as a slowdown in the Chinese economy and fears of increased trade tensions with the U.S. However, the markets were comforted by the +8.5% growth in GGR in November, followed by the +16.6% growth in GGR in December. Macau visitor arrivals continued to be healthy with arrivals from China up 12.1% in October and up 15.3% in November. In late October, the Hong Kong-Zhuhai Macau Bridge was opened to the public. The bridge completes the loop around the Pearl River Delta, which will allow residents on the eastern side of the Pearl River to drive to Macau in a shorter, more direct route. Both of our Macau holdings are well positioned to gain market share in 2019, as they have recently completed sizable investments in new resort and hotel capacity that are in early stages of ramping up.

Macau: Then (2014-15) and Now

Our Macau holdings sold off over 50% in a matter of 6 months during 2018, reminding us of the similar meltdown we observed in 2014-15. However, the external environment and stock specific drivers could not be more different today:

1. In 2015, Macau GGR was down 34% YOY, with VIP down 45% and Mass down 18.5%. In 2018, Macau GGR grew 14% YOY, with VIP up 11% and Mass up 17%.
2. The low margin and highly volatile VIP business accounted for almost two-thirds of total industry revenue going into 2014–15 downturn. Today, VIP is less than 50% of industry revenue and less than 20% of industry EBITDA. In other words, the quality of earnings today is much higher as it is primarily mass market driven.
3. Chinese Government Policy environment (corruption crackdown) was a strong headwind for Macau, especially the VIP and premium mass business, in 2014–15. Policy environment is favorable today.
4. In 2014–15, the industry was gearing up for sizable capital investment to add new supply in Cotai. As a result, the free cash flow outlook was weak. Today, this capex is behind us — MGM China opened its Cotai resort in phases during 2018, and Melco Resorts opened

Morpheus in June. These sizable investments are in the process of ramping up and will drive market share gains and strong FCF growth for our investment holdings in 2019.

5. Overall infrastructure around Macau has become much stronger in the last 3 years with the deployment of the China high-speed rail network and most importantly, the HK-Zhuhai-Macau Bridge that just opened in October 2018. Chinese President Xi Jinping officially opened the $20 billion bridge, highlighting its importance in China's master plan to create its own Greater Bay Area in the Pearl River Delta.

One key factor remains the same today is smart capital allocation by our partners. During the 2014–15 downturn, our partner Lawrence Ho at Melco compounded value per share by buying out the JV partner Crown Resorts at value accretive prices. With a strong balance sheet and capex cycle winding down, Lawrence Ho is again buying back shares in the open market, as well as buying out minorities at Melco Resorts Philippines at highly attractive prices.

L'Occitane International (+3%), the natural and organic based cosmetics company, was a relative contributor in the quarter and year. Core sales grew 4.9% YOY at constant FX in the 6 months ended September 30th and the all-important same store sales (SSS) growth was +2% (vs. -0.1% in the year before). This turnaround was driven primarily by the successful launch of its new skin care product, Immortelle Reset serum. Excluding the recently acquired LimeLife, same-store sales growth was +3.3% in the United States (vs. -6.1% in the year before). Management reiterated their guidance of flat-to-slight improvement in core operating margin despite heavy marketing investments for new product launch, as well as drag from emerging brands.

Bharti Infratel (+5%), the biggest telco tower operator in India, was a relative contributor in the quarter. Its fiscal second quarter results were in line with our expectations with consolidated revenue up around 1% and EBITDA down 7.5% YOY. We believe that we saw the last leg of material tenancy exits, driven by the merger of mobile operators Vodafone and Idea, announced in the quarter. After these tenancy exits flow through the income statement in the current quarter, Bharti Infratel ("Infratel") will have largely absorbed the impact of telco consolidation, where the number of operators decreased from 11 two years ago to effectively 4 players today. The Infratel-Indus merger is on track to complete by June 2019 and will be 14–16% accretive at the earnings per share level. In addition to the organic growth opportunities driven by the high growth of mobile data in India, we believe that there is potential upside from a change of control at Infratel. Bharti Airtel, the 53% parent of Infratel, published its board minutes last month, stating, *"in order to explore a potential monetization of stake in Bharti Infratel Limited ('Infratel') in the future has, subject to the approval of shareholders, approved sale / transfer of up to 32% of Infratel owned by the Company, to its wholly-owned subsidiary, Nettle Infrastructure Investments Limited (Nettle)"*

Brilliance China (-42%), BMW's Chinese partner, was a fast, dramatic and painful reminder to us that State Owned Enterprises (SOE) are generally not minority shareholder friendly, and that the priorities and objectives of the Government take precedence over those of minority shareholders. Brilliance is the Hong Kong listed company that is partnered with BMW in a 50/50 joint venture (BMW Brilliance Automotive) for auto manufacturing in China. It is 42.3% owned by Huachen Automotive Group, which is owned by the Liaoning Provincial Government. Brilliance came on our radar this summer after its stock price fell about 50% to HK$10 per share. This declined reflected fears of weakening new car sales, the lowering of import tariffs from 25% to 15% (reducing the price difference between locally made and imported cars), and an announcement that the 50% foreign ownership limit over automotive joint ventures will be removed from 2022. With Brilliance trading at less than 6x earnings, we thought that the risk of dilution in the JV was more than reflected in the share price. Furthermore, we thought Brilliance management would ensure that any asset sale to BMW would happen at a fair price to protect all shareholders, including the 42% Liaoning Government stake. We were wrong. The national priority of improving relationships with Germany overrode any concern for shareholders. Not only was the purchase price low, but the transaction proceeds will be received only in 2022, when foreign ownership limits on automotive JVs are relaxed. In the meantime, Brilliance China is stuck with paying for 50% of elevated capital expenditure, as BMW Brilliance expands, but will only enjoy 25% of the earnings when their share of the JV reduces from 50% to 25% in 2022. The recent listing of Chinese SOE company Qingdao Haier on the Frankfurt Stock Exchange in October at a 40% discount to its already depressed A-share price was another example of "National Service" that was good for Sino-German relationships but terrible for minority shareholders of Qingdao Haier. We exited Brilliance and re-directed the funds towards companies with better control over capital allocation.

MinebeaMitsumi (-20%), the Japanese manufacturer of high precision equipment and components, was a detractor for the fourth quarter and the year. MinebeaMitsumi supplies Apple with LCD backlight and camera actuators, and market concerns on weak iPhone sales have a big impact on its share price in the short-term. The possibility that Apple will shift entirely away from LCD to OLED backlights further depresses sentiment. However, neither LCD backlights nor camera actuators are viewed as a core business at MinebeaMitsumi, and our appraisal of the LCD backlight business is merely 3% of our intrinsic value. On the other hand, the miniature ball bearings business, which has a dominant 60% global market share and produces the bulk of the company's operating cash flow, continues to compound well. In November, MinebeaMitsumi offered to acquire U-Shin at less than 4x EBITDA. If the deal completes, we expect MinebeaMitsumi to improve U-Shin's margin by extracting significant revenue and cost synergies. CEO Yoshihisa Kainuma clearly understands value per share, and Minebea repurchased 1.5% of shares outstanding in December.

Speedcast (-29%), the largest global satellite communications network service provider, was a detractor for the quarter and the year. Although Speedcast started 2018 on a strong footing, it lost investor favor after the 1H results announcement, giving us an opportunity to meaningfully increase our exposure. In our view, key reasons for the share price decline are:

- Earnings downgrades: The much-anticipated recovery in the Energy vertical (25% of total revenues) has been further delayed with the recent sharp drop in oil prices. This, combined with a one-off investment in a major contract renewal and slower implementation of new contract wins, downgraded its EBITDA guidance twice in the last 6 months.
- Globecomm acquisition: Speedcast completed the Globecomm acquisition during 2018, funded by debt, which increased its net debt to EBITDA ratio to greater than 3x.

It is disappointing to see the anticipated energy recovery being delayed further, but we believe Speedcast is in a strong position to win meaningful contracts when oil exploration and production capex eventually recovers and rigs (especially offshore) come back online. Speedcast is in the service business with a high proportion of recurring subscription revenues and low capex intensity, thus allowing it to sustain high leverage ratios. Founder-CEO Pierre-Jean Beylier has created shareholder value by pursuing value accretive acquisitions and the Globecomm acquisition is no different. We are paying less than 5x EBITDA (including synergies), and funded by cheap debt. While the share price has declined, our intrinsic value estimate has been relatively stable. We are keeping a close eye on its free cash flow generation and debt reduction progress.

Softbank (-35%), the Japanese technology holding company, was one of the top detractors for the quarter, as it 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 $93 billion Softbank Vision Fund. The assassination of Saudi dissident Jamal Khashoggi has prompted business leaders to distance themselves from Saudi Arabia. There are concerns that Softbank's Saudi connections will reduce the Vision Fund's access to investment opportunities. Furthermore, Softbank is a large customer of Huawei, which has been subject to increasing government sanctions and may be forced to remove its equipment from the Softbank mobile network infrastructure. Another reason for share price weakness in the quarter was the perceived flop of the $21 billion dollar Softbank mobile IPO, which fell 14.5% on its first day of trading, and has remained below IPO price. We were impressed that the company managed to sell one third of Softbank Mobile for around 8.5x EBITDA, a significantly higher value than our appraisal of the business, in the face of a potential new entrant (Rakuten) and substantial price cuts by rival NTT Docomo. In the 12 years since Softbank purchased mobile carrier Vodafone KK, management has successfully transformed the company, improving market share from 16% to 25% and increasing operating income by almost 9x. The value of this investment has increased from the purchase price of $15.4 billion in 2006 to the IPO equity value of $66 billion. During the quarter, Sprint received U.S. national security clearance (CFIUS) to merge with T-Mobile U.S. The merger still requires antitrust approval from the Justice Department and the FCC, approvals we expect the company will receive.

Baidu (-31%), the dominant online search business in China, was a detractor for the fourth quarter and year. The departure of Mr. Qi LU from Baidu's COO role created some confusion in the year. However, Baidu's strategy remains focused and clear. During the year, Baidu completed the divestment of its non-core Financial Services and Global app businesses. The IPO of iQiyi provided clarity to investors of the market value of the business, as well as an independent funding source for the online video business. Baidu Core remains healthy with satisfactory progress in AI initiatives. The news feed and AI-related business are already contributing over 20% of Baidu's revenue. In July, Baidu launched the first fully autonomous Level 4 minibus with King Long Motor. The lower growth guidance for the fourth quarter reflected some macro uncertainties in China. The news flow on U.S.-China trade discussion further distorted share prices of Chinese companies. Excluding the market value of net cash and investments in listed companies, Baidu Core is trading at around 8x FCF today. We are confident that Robin Li will create value for shareholders longer term and applaud the $1 billion share repurchase program announced during the year to take advantage of the large disconnect between share price and value.

Portfolio Changes (4Q)

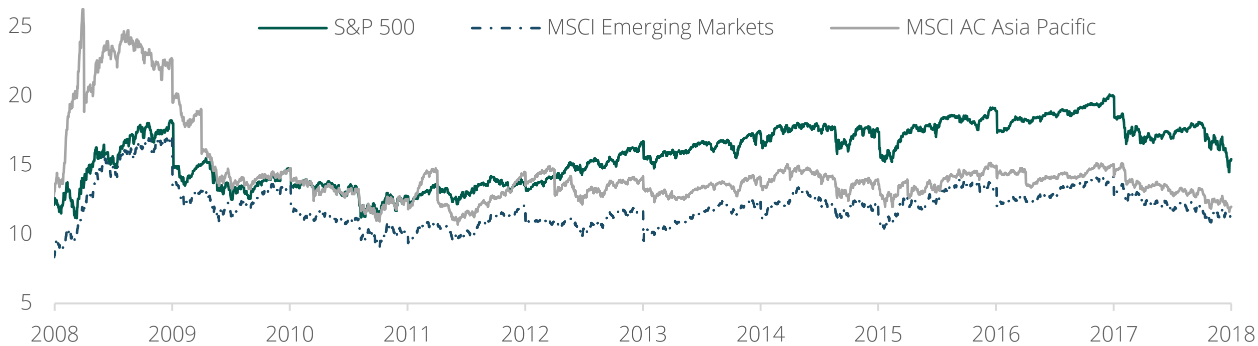
We purchased one new undisclosed company listed in the Mainland China A-share market during the quarter that further increased our exposure to the Chinese consumer. This is the first time that we bought an A-share in the Longleaf Funds, as the A-share market typically always traded at a premium to the H-share comparable. With the CSI 300 Index down almost 28% last year and the consumer discretionary index down over 32%, we found an attractive opportunity listed on the Mainland China exchanges.

Outlook and Opportunity Set

Asia trades at a significant valuation discount to the U.S. and has far stronger (and more tangible) balance sheets, having generally not participated in the debt-fuelled buyback wave at record high prices of U.S. corporates. Asian management teams did not participate in this financial engineering game to anywhere near the same extent as in the U.S. The strength of Asian balance sheets is now a big positive, and if prices slide further, they have the means to acquire their own "cheap" stock and compound value per share. Today, almost 50% of the Topix and around 40% of the Hang Seng Index trade below book, and share repurchase announcements have reached recent highs.

Price-to-Earnings Ratio

31 December 2008 to 31 December 2018



Source: Bloomberg

Just as performance did not reflect portfolio enhancements, we believe the stock prices of most companies in the Fund did not indicate the positive progress that our companies and management partners made throughout the year. Several businesses sold assets for attractive prices, including CK Asset, Baidu, and Softbank. CK Asset sold an office building in Hong Kong for over $5 billion or $4,200 per square foot, the largest single property real estate transaction completed, or about double our appraisal for the building. Softbank completed the largest IPO in Japan, raising $21 billion dollars by listing its Japanese mobile business at an over 50% premium to our appraisal of the business. Softbank sold its 21% stake in Indian ecommerce operator Flipkart to Walmart for 1.6x cost less than a year after investing in Flipkart. Baidu listed and sold some of its shares in online video entertainment platform iQiyi, at a premium to our appraisal, and used some of the proceeds to repurchase discounted Baidu shares.

Bharti Infratel, CK Hutchison, Speedcast, and Minebea announced value-accretive acquisitions and mergers, while Healthscope received an offer that was near our appraisal value. Importantly, the primary business segments at most of our core holdings grew – Retail at CK Hutchison, Core Search at Baidu, Bearings at MinebeaMitsumi, Mass Gaming at Melco and MGM China, and Cosmetic sales at L'Occitane.

Our management partners took advantage of the disconnect between price and value by buying shares personally or having the company repurchase shares. 11 out of our 20 portfolio holdings, collectively representing over half of the portfolio value, have engaged in buyback and / or insider buying in the last few months. The Li family bought over $500mm dollars of CK Asset last year, increasing their stake by almost 2%. Melco Resorts repurchased around 10% of their free float in the third quarter, and we expect them to have repurchased shares in the fourth quarter. In addition, they bought out almost all the minority interest of listed Philippine subsidiary Melco Resorts and Entertainment Philippines at attractive prices. Melco CEO Lawrence Ho has also been an active buyer of Melco shares.

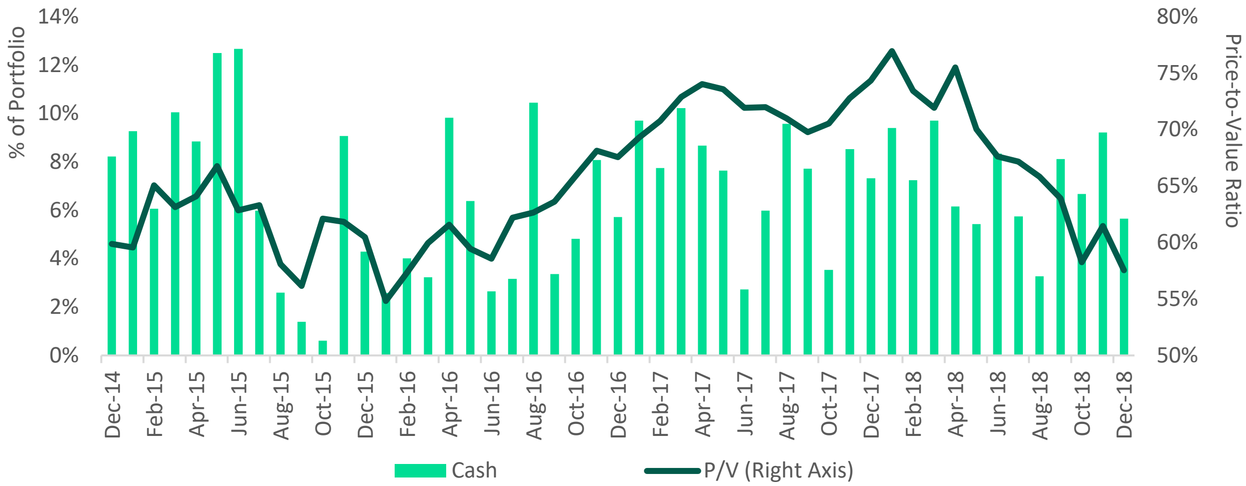
We believe growing free cash flow and earnings per share eventually should translate into stock prices that properly reflect value, whether by investor re-rating, much higher earnings than currently being delivered, or corporate partners taking action to gain value recognition.

We believe the best way to manage against investment risk is to know what we own very well and incorporate conservative-to-skeptical assumptions about the future in our appraisal with a sizable margin of safety on this appraisal. Investing in a limited number of companies, having a broad and deep research network, and engaging with managements are critical advantages in providing the knowledge that may prevent permanent losses over the long-term. In our process, we always consider external challenges that could deteriorate competitive positions, such as technology, government regulation, higher tariffs, and general geopolitical tensions. Most importantly, we have partnered with management teams who, in our view, can control their own destiny in terms of value realization. We are neither pleased nor complacent about 2018 returns. It is our view that the momentum style of investing that has dominated for the past decade is overdue for a reversal. We believe that the attractive price-to-value (P/V) ratio of our portfolio, combined with the underlying strength of the businesses we own and the management teams leading them, can generate strong absolute and relative results going forward and the payoff for 2018 company-level and portfolio-level progress is deferred, but not lost.

Importantly, looking back on a challenging 2018 has not led us to drift away from our disciplined approach. We remain aligned, concentrated, bottom-up, value-oriented, long-term investors who strive to achieve attractive returns by investing within our circle of competence. Over the long-term, investing in great businesses with a margin of safety alongside aligned management teams has proven its power. This approach does require patience at times, but that patience is typically rewarded and allows for us to take advantage of the swings between fear and greed ever-present in the financial markets.

Monthly Price-to-Value Ratio and Cash Levels

December 2014 to December 2018



Source: Factset

Cash ended the year below 6%. Additionally, portfolio repositioning and intrinsic value growth amid stock price declines helped the (P/V) ratio move into the mid-to-high 50s, a particularly attractive discount level, one that has historically preceded strong returns looking over the longer history of our broader strategies. Your portfolio managers have continued to put further personal capital to work to take advantage of the current compelling opportunity set.

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