Letter to Investors

2017 Full Year Review

Jan 2018

Dear Investors,

2017 was a good year for global markets. The S&P 500 was up by 19.4% and the MSCI Asia index rose 30.8%. Over the same period, Lumiere Asia Value Fund returned 19.8%.

Year	Lumiere Asia Value Fund (SGD)	Lumiere Asia Value Fund (USD)	MSCI Asia (USD)	Outperformance/ Underperformance
Oct-Dec 2007	-5.9%	-3.4%	-3.1%	-0.3%
2008	-62.0%	-61.9%	-41.6%	-20.3%
2009	+156.7%	+163.4%	+29.2%	+134.2%
2010	+38.5%	+50.8%	+15.2%	+35.6%
2011	-22.2%	-22.7%	-17.8%	-4.9%
2012	+10.2%	+15.8%	+13.1%	+2.7%
2013	+38.7%	+32.4%	+11.1%	+21.3%
2014	-4.7%	-8.6%	-1.6%	-7.0%
2015	+11.8%	+5.8%	-2.7%	+8.5%
2016	-7.6%	-9.8%	+1.7%	-11.5%
2017	+11.1%	+19.8%	+30.8%	-11.0%
Cumulative	+65.2%	+81.1%	+10.7%	+70.4%

Fund performance is net of fees.

Stocks that did well for us during the year include **Fanhua** holdings. Fanhua is the leading independent insurance distributor in China. With a large part of its business previously focused on the competitive P&C insurance distribution sector, investors shunned the stock, ignoring the fact that its high margin life insurance distributor business was growing rapidly and set to become the focal point of growth for the company. As a result, the stock was trading at its net cash value when we invested. As the market came round to recognising the long term growth prospects of China's life insurance industry arising from a very low penetration rate, the stock got re-rated and almost tripled from our entry price. We will be discussing our investment thesis on Fanhua in the later part of this letter. Another stock that did well for us was **China Taiping Insurance,** which is the 7th largest life insurer in China. Despite premiums growing at more than 20% and the company having the most productive sales force in the industry, the stock was sold down during the China market crash of 2015/2016 and we invested at Price to Embedded Value of 0.6x. The stock rose 83% last year as growth prospects of the China life insurance industry became apparent.

Fang holdings also contributed positively to the fund. The company operates the leading real estate Internet portal in China. However 3 years ago it made a foray into establishing its own physical property agency which caused expenses to ratchet up and at the same time alienated other property agencies which were a core client group of their real estate portal business. The company sank into losses and the share price plunged 85% from its peak in 2014. The company then realised this strategic error and laid out plans to shut down their agency business and that was when we got interested. After seeing visible progress in their restructuring plan to cut expenses, we eventually invested at an attractive valuation of 4.5x peak earnings. The stock started re-rating as the company returned to profitability after successive rounds of cost cutting. Our investment in **China Aoyuan**, a property developer in China, did well last year as well. Due to market concerns on the China property market, the company was trading at very low valuations of 3x P/E and 10% dividend yield when we bought it in late 2016, despite its contract sales growing at 50%. At our investment cost, the contract sales value was 5x their entire market cap and the company makes a 8-10% net profit margin on sales! The management and the company have also bought back more than 3% of their outstanding shares in the preceding year, further confirming our thesis on its undervaluation. The stock eventually gave us more than a twofold return when we exited.

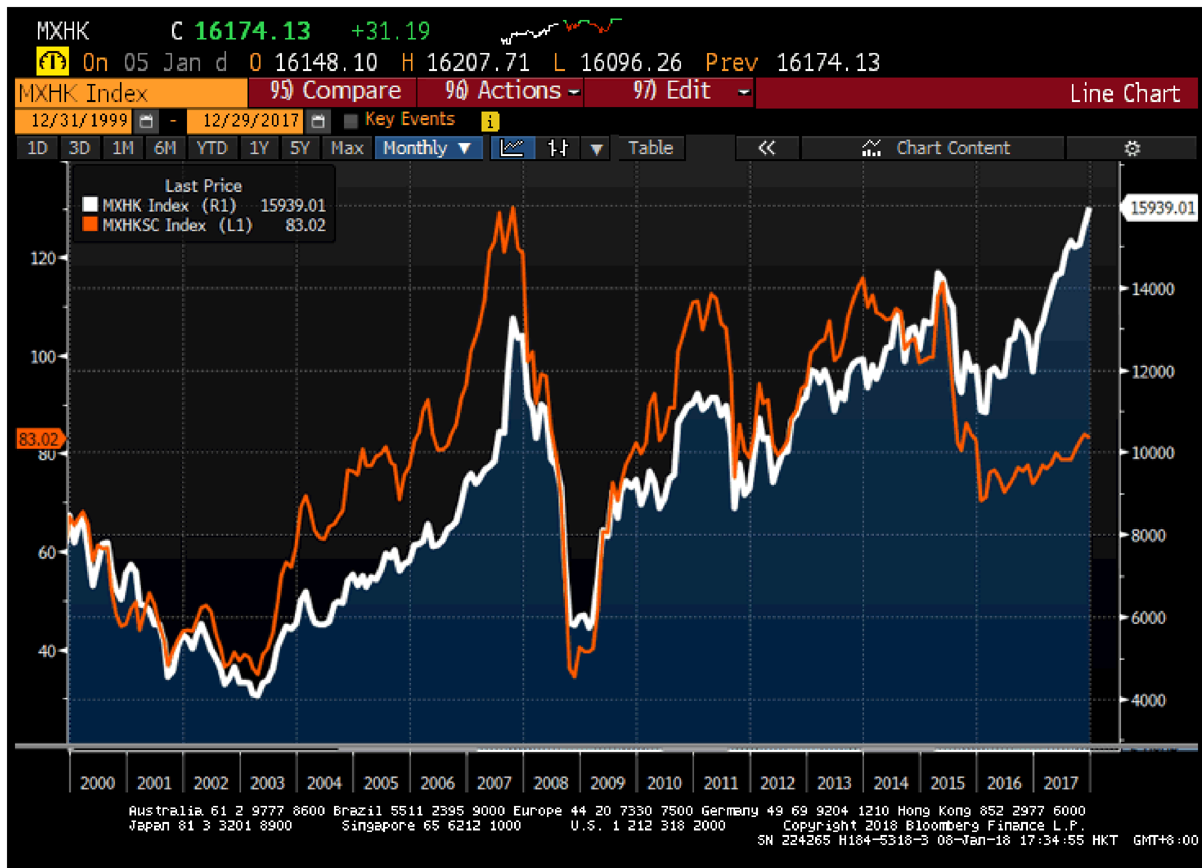
Other holdings that performed well include **Perfect Shape** and **Hopefluent**, stocks we had mentioned earlier in our 2017 half-year letter and 2016 year-end letter respectively. At the start of 2017, Perfect shape was trading at 4x ex-cash P/E and dividend yield of 20% despite its deferred sales revenue stabilising, and Hopefluent was trading at 1x ex-cash P/E (5x gross P/E) despite earnings growth of 30% and its Chairman buying back the shares aggressively. Both stocks have since delivered good earnings growth in 2017 and have appreciated substantially. Despite having doubled last year, Perfect Shape still trades at an attractive valuation of 9x P/E and 11% dividend yield, and earnings are expected to continue growing with deferred revenue having grown 17%. The company is still buying back shares at current price levels and we continue to like the stock. Hopefluent too remains undervalued at 3x ex-cash P/E and the Chairman is still buying the stock at current levels.

Detractors to the fund performance last year include our holding in licensing and brand management company **Global Brands**, which dropped 38% last year as optimistic targets for growth set by the management team were not achieved. **TPV Technology**, a global leading maker of LCD Monitors and TVs, fell 47% from our purchase early last year, as earnings were affected by an increase in panel prices which makes up the bulk of their manufacturing costs. Panel prices have since eased and margins are expected to improve. At current valuations of 0.2x book and 5x normalised P/E, the stock remains poised for a rebound when business conditions improve. **Tao Heung**, a restaurant operator in Hong Kong/China, fell 28% as profits in 1H17 were hit by a drop in consumer sentiment in Hong Kong as well as rising staff and rental costs. However the company has been closing underperforming outlets which should improve its margins. At current prices the stock trades at less than 3x EV/EBITDA and the company's Chairman has been buying the shares, so the stock should do well once visible signs of a profit turnaround emerges.

General comments

The last year has been very conducive for big cap consensus views which has seen indices globally rise considerably, while the contrarian, deep value philosophy which we embrace has not worked out as well. However with valuations of big cap growth stocks no longer cheap, market focus could shift to under-researched and undiscovered small/mid cap stocks which are still trading at low valuations. Due to a lack of investor interest, the MSCI Hong Kong Small Cap Index returned 12.5% in 2017 compared to a 33.3% gain in the MSCI Hong Kong Index (which consists of mainly large caps) – a performance gap of 21%! When that investor focus shifts, the fund is well positioned to benefit as we continue to have a significant exposure to Hong Kong-listed small/mid cap stocks, a market segment that we believe offers the best combination of growth prospects and deep undervaluation.

Below is a chart that shows the big disparity in performance between the MSCI Hong Kong Small Cap Index (orange line) and MSCI Hong Kong Index (white line). Historically small caps have kept pace or outperformed large caps in Hong Kong during past cycles. However since mid-2015, small caps have started to underperform and the gap is now the largest ever!



This in part explains the headwinds faced by the fund over the past 2.5 years as investors shun these smaller under-researched companies by the widest magnitude going back to 2000 with the Index down by 27% over this 30-month period! If the Hong Kong Small Cap Index were to simply recover to its previous highs achieved in mid-2015, the implied upside is at least 37%. In a more optimistic scenario where the Small Cap Index achieves parity with the MSCI Hong Kong Index, it would result in an even greater upside potential of 54%. Either way, it demonstrates how undervalued stocks are in the space we operate in. This severe undervaluation is also corroborated by the quality and valuation of the companies that we are investing in.

One such holding is **Dawnrays Pharmaceutical,** a manufacturer of generic drugs focusing on treatment areas such as cardiovascular and Hepatitis B disease. In particular, its generic drug for Hepatitis B treatment, Leyide, has been registering strong growth since sales started in 2011, and has been gaining market share from the original drug made by Bristol-Myers Squibb, which has a dominant 60% market share in China. Sales and profit growth was interrupted in 2016 as new regulations on the China pharmaceutical industry prompted the company to reorganise its distribution channels and build up its in-house sales team to market directly to hospitals. The drop in profits caused valuations to shrink from 25x P/E in 2014 to 8x P/E currently. After the reorganisation, profits started growing again in 1H17 but despite that valuations continued to stay low. The Chairlady of the company has also been buying the shares recently, attesting to its undervaluation. We had last invested in this company 6 years ago when it was making the transition from low-margin antibiotics to high-margin proprietary drugs business. The near term uncertainties back then had similarly caused its P/E to drop from high teens to single digits, giving us the opportunity to invest and eventually make a more than a twofold return.

Another such holding is **Technovator**, a company which specialises in building and transportation automation, and energy management systems. Its share price had declined more than 70% from its peak in mid-2015 due to disappointing building automation revenue but we believe the market is overlooking strong growth in other segments driven by urban rail network expansion in China as well as the drive towards greater energy efficiency. After we invested in mid-2017, the stock continued to languish at low valuations and is currently trading at 6x P/E despite profits growing at 20% and orderbook growth of more than 50%. The company and its controlling shareholder has bought back more than 4% of its outstanding shares in the last year alone, lending credence to our view that the stock is severely mispriced.

Company Commentary

What you're about to read should not be misconstrued as investment advice. Instead, our intention for devoting the entire section on company commentary is so that readers can understand the thought process underlying our investment philosophy.

Fanhua

Fanhua is China's leading independent distributor for life and non-life insurance products through its online platform (CNPad and Baoxian.com) and offline sales and service network. In 2016, the agency segment catering to individual clients made up 80% of its revenue while the brokerage segment focusing on commercial insurance, group life products, liability and credit insurance for corporate clients made up 13% of revenue. It also provides claims adjustment services which made up 7% of revenue. It now has a network of over 415,000 insurance agents on its platform.

Fanhua was founded in 1998 in Guangzhou, China and originally focused on auto insurance. Even until 2015, over 70% of its revenue came from auto insurance and other non-life products from partners such as PICC, Ping An, Taiping, China Life, etc. But following a series of auto insurance pricing liberalisation measures since 2016, Fanhua started to face severe compression in its auto insurance margins. Commission spreads between what Fanhua received from insurance companies and what they paid out to agents narrowed sharply from 10% in 2007 to 5% in 2016 and a mere 2% in 1H 2017. The deteriorating spreads made the auto insurance business increasingly untenable. Recognising these challenges, the management of Fanhua embarked on an ambitious expansion plan to diversify into new business lines and gain market share quickly in order to achieve economies of scale. It set itself a 5-year target to grow its business 10-fold – to have 1 million sales agents and to achieve RMB100 billion in premiums by 2020. However, this expansion plan also called for a sharp jump in its marketing expenditure from RMB143 million in 2015 to RMB500 million a year from 2016 onwards.

Faced with auto insurance industry headwinds and the prospect of a massive increase in marketing expenditure, Fanhua was shunned by investors and its share price suffered even to the point of it persistently trading below its net cash of $7 to $8 per share between mid-2015 to mid-2017. Investors had also chosen to ignore the fact that Fanhua has been investing substantially in technology over the past few years to build up its various mobile and online insurance platforms such as CNPad, Baoxian.com, ehuzhu.com and chetong.net to serve both consumers and insurance agents. We built up our position in Fanhua during these lean years when it traded around net cash as it was evident to us that Fanhua has been able to leverage on these technology platforms to scale up quickly, especially CNPad, a sales support app which has boosted agent productivity by allowing them to compare policies and transact on the move at all times. Since its introduction in 2014, the number of CNPad users have grown exponentially from 110,000 in 2015 to 212,000 by end 2016. Correspondingly,

Fanhua's quarterly revenue during this period showed 8 consecutive quarters of Quarter-On-Quarter growth.

We also like the fact that Fanhua's business model does not require it to bear any underwriting or investment risk unlike insurance companies, hence its growth will not be constrained by availability of capital. With a highly free cash flow generative business where it generated RMB1.3 billion cumulatively between 2011 to 2015, it was unlikely to burn through its RMB3 billion cash hoard like investors feared even with the higher marketing expenditure. Fanhua's management showed their strong vote of confidence in the business in Jan 2015, when they purchased 7.73 million ADS worth US$54.1 million from CDH Investments, a long-time private equity investor in Fanhua since 2005. This significantly increased the management's stake in the firm from 3.1% to 16.6%.

Furthermore, Fanhua's plan to scale up its business also coincided with favourable developments in the life insurance industry. Previously, China's life insurance policies were mainly lump-sum savings products with short maturity periods of only a few years as many households perceive insurance to be an alternative to bank term deposits. As these lump sum insurance products paid very low commissions, third party distributors like Fanhua were not motivated to sell them and they were instead sold through the bancassurance channels. However since 2015, there has been a significant shift towards more protection-based policies, such as health and accident insurance, which saw a 3-fold jump from RMB160 billion in 2014 to RMB480 billion in 2016 and now make up over 20% of total premiums in China's life insurance industry. These protection-based life policies yielded very attractive commission spreads of 20-35% for distributors like Fanhua in the 1st year, before dropping to 7-15% in the 2nd and 3rd year and then tapering off to 2% by the 6th year and will continue to be paid for as long as the policy is in force. Seeing the opportunity to greatly improve profitability and diversify away from the competitive auto insurance business, Fanhua doubled down on its efforts to increase the scale of its life insurance revenue. It strategically chose to work with a handful of smaller but fast-growing insurance companies such as Aegon THTF, Tian An Life and Huaxia Life who were keen to leverage on Fanhua's technology platforms and huge base of sales agents to scale up quickly.

In 2016, the first full year of its business transformation, revenue jumped almost 80% on the back of a doubling of its agency force to 231,500 sales agents. Net profits only declined 25% to RMB157m despite a four-fold jump in "Selling Expenses" from RMB143m in 2015 to RMB588m in 2016. Coming into 2017, the results of its diversification into the high margin life insurance sector became even more apparent as 9-mth 2017 net profit jumped almost 4-fold to RMB323m. The number of agents and CNPad users went up further to 413,000 and 333,000 respectively. Life insurance revenue as a percentage of its total revenue also improved from 21% in 2016 to 54% for 9-mth 2017 and is expected to increase further due to Fanhua's market share gains and China's low life insurance penetration rate of 2.3% compared to 5.1% in developed countries and over 7% for Japan and South Korea. In line with the significantly improved fortunes of the company, management declared an annual dividend policy of at least 30% of profits in April 2017 and subsequently upped the payout ratio guidance to 50% from September 2017 onwards.

This confluence of positive news has led to a significant re-rating in Fanhua. It now trades at 15x FY18 earnings and 3.3% dividend yield. With a third of its market cap in net cash, ex-cash P/E still remains reasonable at 12x. Our investment in Fanhua has appreciated by 170% but we continue to hold onto our position as we foresee continued strong growth ahead for the company, backed by both market share gains and rising insurance penetration in China.

As always, please feel free to let us know if you have any clarifications regarding your investment in the Lumiere Asia Value Fund.

Yours truly,

WONG Yu Liang and **Victor KHOO**

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