A View from Asia

FOR PROFESSIONAL INVESTORS ONLY

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Dogma – an official system of principles or tenets concerning faith, morals, behaviour; a doctrine laid down authoritatively as incontrovertibly true. It serves as part of the primary basis of an ideology or belief system, and it cannot be changed or discarded without affecting the system's paradigm, or the ideology itself.

First of all, a note of thanks to clients who have entrusted us to manage your funds over the past four years. 30th September 2015 marked the fourth anniversary of our two Asian funds, and we would not be here without your support. It has certainly been challenging at times, but always enjoyable, and we thank you for your confidence in us.

From more than a couple of decades of living and investing in Asia, it strikes us that several dogmas have become entrenched in the collective consciousness. Many that relate to China, in my view, are based on the presumed omnipotence of the Chinese Government. Examples include: high GDP growth rates can continue for a very long time; urbanisation in China has a long way to go; and a smooth rebalancing of the economy away from investment-led growth to consumption-led growth will happen.

Over the past four years, I've written enough on the opportunities and challenges we have faced, in Asia and particularly in China. The 'View from Asia' for July and August this year laid out my thinking on what we expect to transpire in China on the economic front. I quote Janet Yellen, the Chair of the Federal Reserve, from her press conference last week explaining their decision not to raise rates in the US.

'Developments that we saw in financial markets in August, in part, reflected concerns that there was downside risk to Chinese economic performance *and **perhaps concerns about the deftness in which policy makers were addressing those concerns**.'* (my emphasis)

Enough said about China. In previous notes, I mentioned Indonesia and Thailand as areas of interest for potential investment opportunities. With the prevailing global uncertainty, it is possible that there is more downside to earnings and valuations in these two countries. We are watchful as the excesses in these two economies are starting to unravel.

Credit excesses explain dislocations

I am a firm believer that credit excesses are the root of all dislocations. One of the better books on the topic of credit, human excesses and their effects on economies and society is 'The Bubble that Broke the World', by Garet Garrett, written in 1931. Garrett was a libertarian in the classic mould and would have shuddered to see where we've got ourselves today in a world dominated by credit.

This long quote from his introduction (Cosmology of the Bubble – The Lord giveth increase, but man devised credit) is worth re-reading to set the context to explain what seems to be happening in Indonesia and Thailand. These words were written in 1931, yet they ring true today.

"Second, a social and political doctrine, now widely accepted, beginning with the premise that people are entitled to certain betterments of life. If they cannot immediately afford them, that is, if out of their own resources these betterments cannot be provided, nevertheless people are entitled to them, and credit must provide them. And lest it should sound unreasonable, the conclusion is annexed that if the standard of living be raised by credit, as of course it may be for a while, then people will be better creditors, better customers, better to live with and able at last to pay their debts willingly. Result: Probably one half of all government, national and civic, in the area of western civilization is either bankrupt or in acute distress from having over-borrowed according to this doctrine. It has ruined the credit of countries that had no war debts to begin with, countries that were enormously enriched by the war trade, and countries that were created new out of the war. Now as credit fails and the standards of living tend to fall from the planes on which credit for a while sustained them, there is political dismay. You will hear that government itself is in jeopardy. How shall government avert social chaos, how shall it survive, without benefit of credit? How shall people live as they have learned to live, and as they are entitled to live, without benefit of credit? Shall they be told to go back? They will not go back. They will rise first. Thus rhetoric, indicating the emotional position. It does not say that what people are threatening to rise against is the payment of debt for credit devoured. When they have been living on credit beyond their means the debt overtakes them. If they tax themselves to pay it, that means going back a little. If they repudiate their debt, that is the end of their credit. In this dilemma the ideal solution, so recommended even to the creditor, is more credit, more debt."

Waning consumer demand in action

Let's look at two proxies for consumer demand represented by home improvement retailers: Ace Hardware in Indonesia and HomePro in Thailand.

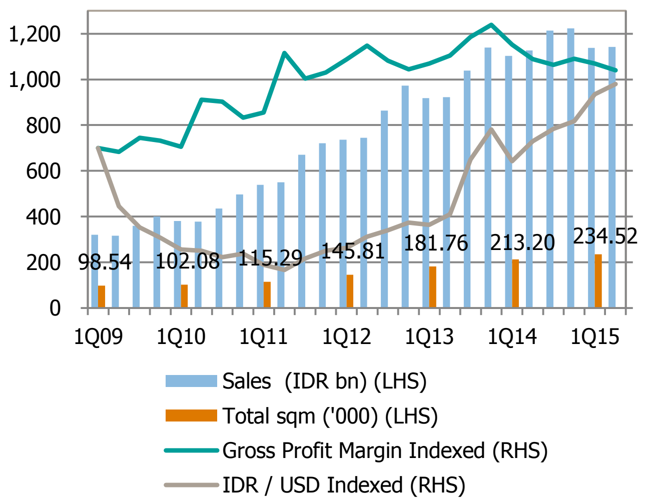
For Ace, its long-term business prospects are indeed very good. A large and young population; home ownership at extremely low levels; rising aspirations; and increasing internet connectivity all point to a potentially profitable business opportunity. The company started in 1995 as a master franchisee for Ace Hardware Inc. U.S. and today has 116 stores across Indonesia. Ace listed in 2007, coinciding with the boom in commodity prices that helped the Indonesian economy. Selling home furnishings, hard goods and building materials, sales and profits increased steadily. Over the past eight years, Ace has opened stores outside Java, traditionally the heart of economic activity for Indonesia, into Sumatra and Kalimantan, where the boom in commodities was most visible. Rising wages, not just from booming plantation and coal mining but state-imposed increases in minimum wages, were confidence boosters for the company. As the Indonesian rupiah (IDR) strengthened post the 2008 financial crisis, Ace, which imports over 80% of its products, witnessed a surge in gross profit margins (GPM). Indonesian consumers, it seemed were enjoying an ever rising standard of living. Credit growth in Indonesia was running at 25% compounded growth for almost

5-6 years in a row, which also helped spread prosperity.

In 2015, things are very different. Since the 'taper tantrum' of May 2013, the IDR has depreciated almost 32% against the US dollar. The costs of doing business for Ace have risen substantially as electricity prices and wage costs have surged. Even though nominal wages have risen, in real terms consumers are hurting as inflation has far exceeded those wage gains.

The chart below shows how Ace expanded retail space by 2.5 times since 2009; sales rose 3.6 times over the same period. Notice also the inverse relationship in the indexed performance of the IDR and Ace's GPM. The IDR was at its recent strongest level between 2010 till mid-2013; GMP for Ace peaked in late 2013. The market cap of Ace peaked at close to US$1.8 billion in mid-2013; today it stands at US$600mn – back where it was in 2010!

Not so Ace: gross profit margins roll over at Indonesia's Ace Hardware as the rupiah weakens



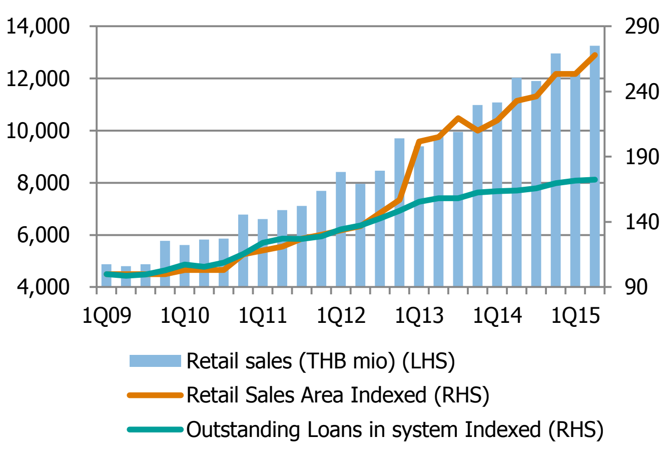
Source: Deutsche Bank

Customers are starting to cut back on consumption. Growth in Indonesia is weak, credit growth is slowing. Same-store-sales growth is faltering at Ace as it has expanded aggressively. I anticipate the company will have to consolidate and even cut back on some retail space. This will be driven by falling margins, rising costs and deteriorating cash flows. As this happens, we might get a chance to own this business, just as investor pessimism peaks.

HomePro (HP) in Thailand paints a slightly different picture. A much more developed country, Thailand, too, benefited from a commodity price boom, particularly in rubber and rice. This boom for farmers and rural residents was extended by the rice-buying scheme, where the government promised to buy rice at much higher prices than global markets. The unintended consequences of this policy were to incentivise farmers to plant even more rice, while some resorted to smuggling in rice from neighbouring countries to sell to the Thai Government. As farm incomes rose, banks and businesses in Thailand extrapolated this rise into the future and expanded loans as well as businesses with a rural focus. In 2012, the Government, in order to boost growth and its own popularity, started a first car buyer subsidy scheme. On our trip to Thailand in late 2013, we learned from many participants that individuals had blindly bought cars, not thinking about interest payments, insurance or even petrol expenses in the subsequent years. By 2014, hire purchase companies and banks were taking write-downs as they repossessed cars in droves. Unsurprisingly, car sales in Thailand subsequently plummeted.

HP was one of the businesses who expanded retail space, but unlike Ace, it also saw competitors eyeing its markets. In Thailand, the currency was much better behaved, but easy credit growth has been the culprit. In the chart below, you can see how HP grew its retail space almost 2.7 times from 2009, while system bank lending in Thailand grew almost 1.75 times. This was when nominal GDP grew only 1.35 times over the same period. The Thai Government has had to take a loss of close to US$9 billion on the rice subsidy scheme. Farm and rural incomes are now falling as the commodity boom tapers, while famers and rural citizens demand more support from the state to bolster their debt-laden finances. HP, in my last meeting with its management in August 2015, admitted it had expanded too fast and will cut back on expansion. The company was, however, very keen to explore business opportunities in Malaysia, where it has started just one store. Time will tell whether they accept this expansion as folly.

Thailand's HomePro goes into slow-mo



Source: Deutsche Bank

No new paradigm

Generally speaking, the linkage between robust consumer demand and benign macroeconomic conditions is a little-acknowledged fact. In particular, periods of a weak US dollar and falling interest rates create a virtuous loop that leads many companies and investors to believe that a new paradigm of rising consumer demand is upon us. Time and time again, many businesses forget that benign macroeconomic conditions bring forward and amplify demand, only to normalise as economies slow and liquidity gets scarce. As emerging markets in general struggle in a strong US dollar environment, our endeavour remains firm – to find businesses that either have the sustainability over economic cycles or management teams that are willing to adapt and change to survive the downturns. Hope is never a good strategy, but we do think Indonesia and Thailand show signs of accepting a very tough economic environment. Timing is always the difficult part to predict, but in the next 6-12 months, we could be increasing exposures to these two countries.