ASTRAL VALUE FUND

JUN 2017

	Jun 2017	YTD 2017	1 Year	Annualised from Inception	Inception to Date**	Outperformance since Inception
Astral (Class B)	0.2%	13.1%	22.7%	8.3%	18.8%	
MSCI Asia Pac	1.3%	14.5%	19.9%	0.4%	0.8%	18.0%
HSI	0.4%	17.1%	23.9%	-4.0%	-8.4%	27.2%
FSSTI* (USD)	1.0%	17.7%	11.2%	-5.2%	-11.0%	29.8%

*FSSTI was rebased to USD using the month end exchange rate
** Inception date was 1 May 2015

HALF YEARLY COMMENTARY

Dear Partners and Friends,

Markets moved up decisively in the early first half of 2017 as positive sentiment abounded. The US stock markets reached record highs as more signs emerged that the US economy was finally recovering from its long malaise since the global financial crisis in 2009. Hope that Trump's new policies would galvanise the economy further, prompted more investors to pile into equities. The S&P 500, led by Technology stocks, rose 8.5% for the first half of the year. In Asia, reports of China's demise turned once again into "Cry Wolf" as the world's second largest economy started growing again as evidenced by the rising PMIs and exports. Key commodities such as oil, coal and iron ore started rebounding from last year's multi-year lows, though volatility remained high. While the recovery in China's economy was not reflected in the A-share market, the HSCEI and the Hang Seng both rose double digits for the first half of the year, suggesting returning interest from international investors.

The positive sentiment was such that the overall market brushed aside two actual rate rises by the Fed. That the market even held up to the announcement of the imminent end of Quantitative Easing, one of the main overhangs of the market in the last few years, was evidence that the optimism of investors is sky high. Banking stocks were big beneficiaries, as their valuations at the start of this year were still low. Analysts and investors rushed into them thinking that banks could benefit from rising interest rates through higher interest margins and believing that non-performing loans had hit a trough in 2016.

In the backdrop of this rosy upturn in the market, we were pleased to rally together with the market and achieve a 13% return for the first 6 months of 2017. While we do see risks emerging after the massive rally, we remain 95% invested. Being bottom-up value investors, our guiding principle remains buying cheap relative to the valuation of the company. We still see value in many of our holdings. While some of them have rallied significantly in price, their business metrics exhibited an even stronger growth.

Portfolio Movements

Despite the huge rally in the market, turnover ratio for the fund in the last one year remained at a low 42% as we remained positive on most of our holdings. We adjusted our portfolio slightly by exiting selected stocks which have rallied above our fair value estimates. Exits were primarily the deeply valued situations because they have rallied to a level where we feel they would continue to trade range bound in the absence of a catalyst. Growth, franchise and turnaround situations continue to be the major part of our portfolio, and they constitute two-thirds of our portfolio. Below is a table showing the changes in

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our equity portfolio EV/EBITDA and PB. In the last six months, our EV/EBITDA rose slightly to 7.4x even though PB has risen substantially.

Date	P/B**	EV/EBITDA**
30 Jun 17	1.34x	7.4x
31 Dec 16	1.08x	6.6x
30 Jun 16	0.89x	7.0x
31 Dec 15	0.88x	7.3x
30 Jun 15	1.26x	9.0x

**P/B and EV/EBITDA gives a flavour of our fund's valuations. Our view is that EV/Owner's Earnings is a more accurate way to assess a company's current valuation. Unfortunately, even though Buffet mentioned the formula for Owner's Earnings in his letters as early as 1986, the use of the formula in mainstream finance is almost non-existent.

Investment Situation Showcase

Below is an investment example to explain our investment process for a deep value situation for our fund. Please note that this is not to be considered as any form of investment advice.

It has been said that there is a price for everything. This applies to deep value investing as well as we feel that there is a cheap price to pay for to own almost any asset. At Astral, we describe ourselves as generalist investors and are sector agnostic. This means we can invest across all businesses or industries where we think we can understand the business and gauge the intrinsic value.

Our definition of deep value situations which can make it into in our portfolio is that the company must trade way below its intrinsic value. Typically for a deep value situation to make it to our portfolio the company would trade probably less than 1/3 of our calculated intrinsic value and/or less than 3x its cash earnings, excluding the cash on hand. While we do not require a catalyst for deep value situations, we do require management to have a clear and feasible strategy to improve the valuation or expect the future earnings of the company to improve.

Lai Fung (1125HK)

Lai Fung is a subsidiary of the Lai Sun group of companies and is the property group's main investment property vehicle in China. It owns properties mostly in tier one cities such as Shanghai, Guangdong and, lately, in Hengqin island beside Macau. The management used to be current owners, who had no clear strategy on how they intended to operate the business. This changed few years back when they employed professional managers to run the company. The new CEO came up with a strategy to develop new projects for recurring income, in addition to its property development business.

As opposed to many other businesses, the advantage of investing in a company backed by properties in first tier cities in China is that you can verify the existence of the asset. In addition, we noted that Capitaland invested into Lai Fung at HKD0.40 in 2007. After verifying the assets and talking to the new management on the future strategy, our conclusion was that the group now has an executable strategy with landbank and financing in place as opposed to previously developing her landbank haphazardly. Gearing remains low at 30% with many of its China projects contributing cash flows. The company was well positioned to achieve what they have set out to do.

The clincher though was the price. We invested in the company in late 2015 when markets swooned over China's slowdown. At our point of investment in Oct 2015, we bought in at the range of HKD0.125 and this was a valuation of less than 0.2x its stated book value. In addition, this was what was stated in

the accounting book and does not include the potential increase in value of the properties if they were subsequently fully developed. The irony was that even as the slide in property stocks' prices continued, physical property prices in first tier cities such as Shanghai and Guangzhou continued to climb up more than 20% annually in 2015 and 2016. This gave us confidence to add to our positions in 2016 as our AUM increased. We first mentioned it as an investment idea during an investment conference held with local financial website Bigfatpurse in late November 2016.

In December last year and early this year, markets recovered especially in terms of sentiments towards the Chinese property markets. The stock rallied 50% from our cost price and we started exiting the stock. This was not because we felt the stock had rose to its fair value but rather, we believed that our cash would perform better in other investing situations.

On close analysis, we feel that the price paid gave us the edge in this case. Our years of experience in investing have let us to conclude that there are no businesses that are too lousy that should not be bought at any price. On the flip side, there are no businesses that is so good that must be bought at any price. This subject of price versus value is best summed up by Howard Marks:

> *The most important thing – above all – is the relationship between price and value. For a value investor, price has to be the starting point. It has been demonstrated time and time again that no asset is so good that it can't become a bad investment if bought at too high a price. And there are few assets so bad that they can't be a good investment when bought cheap enough*
>
> *-- Howard Marks.*

What We Have Learnt

Usually we place this section before our investment showcase as we believe that we learn more from our mistakes than analysing success. In this newsletter though, we have decided to put this after the showcase as they are related.

Deep value investing may seem to be a sure way to make good money in stock market. After all, buying companies at 30 cents to 40 cents to a dollar seem like a sure way to make money. Recall that we mentioned earlier "there is a cheap price to pay for ***almost*** any asset". Unfortunately, value traps abound in deep value investing. The axiom "Some stocks are cheap for a reason" rings true especially in deep value investing. Value traps include declining industries such as the death of print media or the emergence of new competitors with new way of doing things like ecommerce versus retail. Other situations of value traps include misleading accounting or aggressive management accounting such as channel stuffing or even outright frauds. The most famous deep value trap happens to be Buffett's purchase of Berkshire textile mill. It was bought as a Graham type of net-net investment at extremely low PB and PE ratio. It turned out to be a value trap as the future earnings just continued to tumble as the textile industry was essentially commoditized, which meant only the lowest cost producer could make profits. The high fixed and variable cost structure in US doomed all US textile companies to cheap low-cost textile producers overseas from China and Africa.

The other danger for deep value investing without catalysts is that the time for a stock to reflect its value may be not worth the time investing. For instance, a stock may be undervalued but the majority owner

manager is not interested in letting the stock price reflect its true value. This experience became real for us when we invested in UOB Kay-Hian and subsequently divested at a small loss over the last year. On the face of it, the stock does not look like a value buy. However, we felt that the market was under-pricing the bulk of the assets, which were essentially marked to market securities that are revalued at the end of each quarter. The cash and securities, net of all its liabilities, more than cover the market cap of the company. This valuation of assets however does not consider the value of the brokerage business which has significant value. If we do a simple liquidation, the value of the business of brokerage is free. The Wee family obviously recognises that their stock is cheap and conducts frequent share buybacks on their own.

Nevertheless, when we dug deeper, we discovered that the brokerage is run by the younger son of Wee Cho Yaw while the bank is run by the eldest son. In general, both do not interfere with the running of each other's businesses. Each seems content to do small share buybacks to increase their stake in their business. This meant that UOB Kay-Hian is very unlikely to hit its fair value in the short to medium term. Perhaps one day, one of them will buy out the other but this might take an inordinate amount of time. Hence this might end up being a rather long-term investment, which at current level of discount does not give us enough upside. Lord Keynes famous quote "In the long run, we are all dead!" rings true.

Our View of the World Now

After a great first half of the year, our reflex mindset is that of slight caution as the margin of safety has been reduced. There are a few major risks which are of concern. First is the high valuation in the US. While there are increasing expectations that the US economy can continue to rally, we are generally cautious and have reduced our positions in the US market to less than 2% of our portfolio.

The other major risk is that higher interest rates juxtaposed with continued rising property prices in Asia makes the risk of a strong correction in property market very high, echoing what happened in Japan, Asia and US in 1989, 1997 and 2008. Nowhere is this credit squeeze more real than inside mainland China for the Chinese companies. The government's determination to close the financing taps for old economy activities and property development is making refinancing very difficult for Chinese corporations. Anecdotally, many small property developers and contractors have gone bust, after having difficulties refinancing or collecting their payment from stakeholders.

Geopolitical issues too continue to be a concern. North Korea's recent successful firing of its intercontinental ballistic missile theoretically puts the entire Asia and parts of America at risk. Throw in a US president who acts in an unpredictable manner, we might not be far from the spark of a damaging war.

While there are concerns, we have chosen to focus on the potential opportunities that can arise out of these angsts. Our investment strategy continues to be the same: To find mispriced assets. We are most excited about finding the franchises of tomorrow. We own companies with the largest market share in China and are angling to be top global brands. Many of them are low-cost leaders owing innovative IPs and have made global inroads by buying top brands overseas.

Make a guess before turning to the next page. A US company IPOed in 1992 at an IPO price of 35 cents, after adjusting for stock splits. It currently trades at 58 dollars. That is a return of 165,000% and an annual compounded return of 23% in 25 years, excluding all the dividends it has paid out to date. What company is it?

You may think it is probably a high-tech platform or pharmaceutical company which can deliver such returns, but it is not. It is a company that is in the food business. I hope you guessed it. Starbucks! The

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success of the company proves that franchises of tomorrow do not necessarily have to be tech related game changers to give rich rewards for investors. Something as traditional as F&B can do it. With the rising income class in Asia and thousands of entrepreneurs in Asia are dreaming of making it big, we have no doubt that more Starbucks are in the making. At Astral, we believe that we can find these companies early, grow with them and at the same time bring great rewards to our partners.

Acknowledgement

Once again, we wish to thank our partners who have joined us along the journey. We treat all investors in our fund as our partners because we believe that just like a partnership, we are entering a long-term relationship with an implicit undertaking that all partners will share the risks and profits together.

Astral's commitment to this long-term partnership manifests in two ways. Besides the managers investing a substantial part of our wealth in the fund, we structure our fund to grow our collective wealth sustainably without taking excessive risks. We do this by structuring our fund fees into a modest annual fee with a corresponding lower than average market performance fee. This allows us to survive in all market conditions and not take huge risks to earn performance fees. Furthermore, we add in a high watermark, which means we only get paid performance fees if we exceed our previous best NAV. We believe that we have a structure which rewards long term growth in wealth and we are confident of achieving the returns that we promise investors.

We welcome potential partners to contact us at enquiries@astralasset.com for more information.

Sincerely,

Astral Asset Management

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