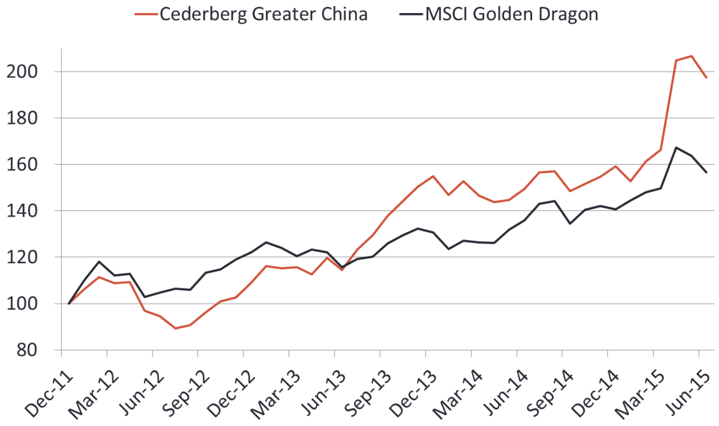
# CEDERBERG CAPITAL

## Q2 2015 LETTER

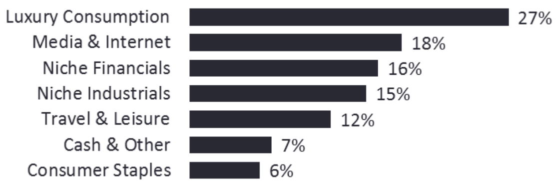
### Performance Chart[1]

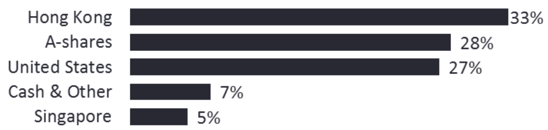



### Performance Table[2]

| Net Returns in US$ | Cederberg | MSCI Golden Dragon | Peer group |
|---|---|---|---|
| Since inception | 98% | 57% | 54% |
| Since inception annualised | 21% | 14% | 13% |
| 3 years annualised | 28% | 14% | 14% |
| 1 year | 32% | 15% | 17% |
| Year to date | 24% | 11% | 13% |
| 3 months | 19% | 5% | 7% |
| 2014 | 3% | 8% | 4% |
| 2013 | 42% | 7% | 10% |
| 2012 | 9% | 22% | 18% |

### Exposure by Category[3] and Listing



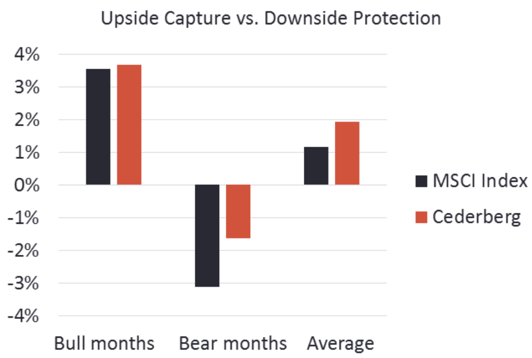




### Top 10 Holdings in alphabetical order[4]

| Stock | Industry |
|---|---|
| Brilliance China | Automaker |
| CMCDI | Asset Management |
| Clear Media | Outdoor advertising |
| Emperor Entertainment | Hotel & leisure |
| Gree Electric | Household appliances |
| Kweichow Moutai | Distillers |
| Noah | Asset management |
| Nu Skin | Household & personal care |
| Straco | Tourism facilities |
| Wuliangye Yibin | Distillers |

### Key Characteristics[5]

| | | | |
|---|---|---|---|
| Price/Earnings Ratio (2015) | 13.7x | Fund Assets | $114m |
| Price/Book Ratio | 2.7x | Total Assets | $166m |
| Dividend Yield | 2.7% | Number of Holdings | 19 |
| Return on Equity | 22% | Top 10 Holdings | 63% |
| Net Cash to Market Cap | 8% | Upside Capture[6] | 104% |
| Median Market Cap | $2.3bn | Downside Capture[6] | 52% |




### Key Features[7]

| | |
|---|---|
| Fund | Cederberg Greater China Equity Fund |
| Strategy | Long-only absolute return equity |
| Legal status | Cayman mutual fund |
| Dealing | Monthly with 30 days notice |
| Initial minimum | US$100,000 |
| Benchmark | MSCI Golden Dragon Index |
| Management fee | 1.5% p.a. |
| Performance fee | 20% of outperformance above MSCI GD Index; payable after 3 years if fund beats 6% p.a. |
| Custodian | Bank of America Merrill Lynch |
| Auditor | Deloitte |
| Administrator | Charter Group Admin |
| Cayman counsel | Maples & Calder |
| US & UK counsel | Schulte Roth & Zabel |
| Contact | Dawid Krige; Borch Du |
| E-mail | info@cederbergcap.com |
| Telephone | London: +44 207 871 7228<br>Shenzhen: +86 755 8669 2456 |

# Q2 2015 LETTER

**Our thinking**
Regular readers (I may be flattering myself) will know we use our quarterly letters to illuminate our long term-oriented investment approach and our views on opportunities in Greater China. With this in mind, we have made some small changes to the format. We've increased the disclosure of performance and portfolio data, and have dropped the discussion of recent price movements as it doesn't match our long term thinking. We will also limit discussions of existing holdings to protect our intellectual property and to mitigate any behavioural biases, though we will continue to discuss investments we've exited in future letters. Please contact us if you have any questions or suggestions; we would love to hear from you.

**True or False? Take our China quiz**
The world's second largest economy and second largest stock market remain shrouded in controversy. Bearish articles are published daily and short sellers are clamouring for a collapse. Why would anyone want to invest in China today?

We believe China is misunderstood by many commentators, investors and capital allocators. These misunderstandings are not altogether surprising, given the size, complexity, and pace of change of China's economy and its financial markets. The upside from this is that it has led to fewer people analysing Chinese companies, which creates more opportunities for dedicated China specialists like Cederberg. On the other hand, it makes marketing a China fund harder. Given the choice, we much prefer this scenario to the alternative, i.e. an easily marketable proposition but with inferior investment opportunities.

In this issue, we put six widely held views on China to the test, and discuss where we differ from consensus. Pencils ready...

*1. Economic growth is collapsing?*
China's growth in 2015 is likely to be the slowest in over two decades. Officially it will likely be around 7%, but in reality it might be a percentage point or two lower. Is this the start of the hard landing some commentators have forecasted for years?

We aren't economists and don't spend any time on the "dismal science", but we've developed some macro views from observing many Chinese companies and industries over the years:

- Slower growth is inevitable: China cannot continue to grow at 10% because its base is much larger than before
- Productivity is likely to remain a significant growth driver: ongoing reforms and a low GDP per capita (one-sixth of the US) provide ample scope for further gains
- Our best guess is 5-6% GDP growth for the next decade
- Domestic consumption is the future: due to a variety of reasons including government policies, a stronger social safety net, and lower growth in investments and exports.

For a better explanation of the country's long term growth trajectory, we would recommend The One Hour China Book. We will send the first ten people to respond a copy; the rest of you won't have to break the bank as it is available for $5 on Amazon.

Though growth in China is undergoing a structural normalisation (which is currently coinciding with a cyclical trough), investors may actually be better off in this environment. Rampant growth historically led to overcapacity and negative free cash flow: bad news for investors. A slower growth environment will reduce overcapacity and force companies to focus on generating free cash flow, which could be a more benign backdrop for investors.

*2. Real estate is a bubble?*
China's "ghost towns" (newly constructed towns devoid of people) have been discussed at length. The one thing we know about China is that it has too much housing stock and hence a real estate bubble that is ready to burst, right?

As with many things in China, the reality is more complicated. Firstly, the country is big and diverse: just as Manhattan and Phoenix aren't representative of the US housing market, Beijing and Ordos (one of the more famous ghost towns) aren't representative of China's. Secondly, given the pace of urbanisation, it is inevitable that supply and demand won't always match up everywhere (e.g. current oversupply in Ordos and undersupply in Beijing.) Thirdly, income growth has outpaced price rises: over the past nine years urban household disposable incomes grew 12% p.a. vs. 9% growth in average prices per square meter. Finally, homeowners' modest debt (the system-wide loan-to-value ratio is below 60%) means the risk of a US-style housing crisis is low .

While examples of ghost towns and property speculation exist, we believe accounts of these have been overblown; we don't expect real estate to pose a systemic risk any time soon.

*3. Chinese equities are a bubble?*
Hardly a day goes by without an article about millions of people without high school diplomas using borrowed money to speculate in frothy A-shares (companies listed in Shenzhen and Shanghai).

Like its economy and its property market, China's financial markets are complex. Roughly 5,000 companies from Greater China are listed on various exchanges, including Hong Kong, Taiwan, the US, A-shares, and many others. Because of past capital controls and other barriers, different exchanges have tended to attract different shareholder bases that all behave quite differently.

Many A-shares are wildly over-priced, which will inevitably lead to people losing money (and which may even impact consumer confidence if the current sell-off continues). However, there are exceptions: the three we own trade on 8-15x P/E multiples, have net cash balance sheets, and are growing at double digit rates.

Furthermore, many of the Chinese companies listed elsewhere are outright bargains. The median P/E of all Hong Kong-listed shares is a modest 14x, compared with 20x for US companies. Likewise, we continue to find a lot of value among US-listed Chinese companies. Others have also taken note: in the year to date there have been 25 buyout announcements of US-listed Chinese companies, including two of the fund's holdings, **Home Inns** and **21Vianet**. A-shares aside, we find market valuations attractive.

CEDERBERG CAPITAL

## Q2 2015 LETTER

*4. Local investors do best?*
A view that seems to be quite popular is that China is all about local connections, and hence a China fund should be managed by a Chinese portfolio manager based locally.

We tested this assumption by analysing the 50 or so Greater China funds on Bloomberg that have a ten year track record to gauge whether there is a relationship between portfolio manager location/origin and returns. Disappointingly, the results were inconclusive (the bulk of funds, winners and losers, have been managed by Chinese managers based in the region). We then ran the same test on the universe of 300 or so Japanese equity funds. Japan isn't China, but like China it has a unique culture and language, and hundreds of companies uncovered by brokers, all perceived as challenges for foreign investors. The results were fascinating: of the top 10 funds, eight were managed by non-Japanese investors, of which six were based outside the region.

At Cederberg, our process is research-driven, with a lot of it conducted on-the-ground in China. That is why Charles is based in our Shenzhen office and why our London-based analysts spend at least a month per quarter in the region. However, managing portfolios from London provides us with a unique perspective that is both global and local (this might explain why our portfolio tends to look very different from those of our peers). Arguably it also makes it easier for us to control our emotions and not succumb to all the short term "noise" and market chatter in places like Hong Kong and Shanghai.

These reasons probably explain why investors based outside of Japan have been so successful historically. It will be interesting to see how it plays out in the long run in China as more investors pursue a similar course of action.

*5. Growth beats value in China?*
Conventional wisdom holds that if you're going to invest in China, you should invest for growth given the rapid growth the region has traditionally offered. While there are examples of successful growth-oriented investors in the region, value investors have come out tops: over the past 15 years, the MSCI China Value index has gained 16% per annum vs. 6% for the Growth index.

We are value investors at heart. However, we aren't looking for Ben Graham's "net-nets" or the "cigar butts" of the early-Buffett years. In our experience "cheap" often stays cheap in China, hence we are better off buying undervalued quality, i.e. good businesses managed by trustworthy people. We love growth, if through our research we can gain confidence about the likelihood it will be realised. However, we are careful not to overpay for growth, hence we always insist on a significant margin of safety, regardless of a company's growth potential.


*Source: Bloomberg*

*6. Who cares? Chinese equities is too niche an asset class for me*
'Why should I invest in China if it is only 3% of global stock indices?'. This is true today, if only because index providers have been slow to incorporate what is already the world's second largest market. We are confident China will become a lot more relevant to global investors as the market could easily represent 10% of global indices within the next 5-10 years.

In addition, the case for China is compelling for the following reasons. Firstly, one can find great companies trading cheaply. Cederberg's portfolio is high quality (19% return on invested capital), yet it trades for less than 12 times earnings (adjusted for net cash and an outlier), with profits growing 15% this year.

Secondly, the market is arguably far less efficient than most developed markets. We have discussed the sources of these inefficiencies in previous letters, but a brief recap:

- Limited broker research: the average small cap ($100m to $1bn market cap) listed in China, Hong Kong and the US are covered by 1.3, 2.2 and 4.5 analysts respectively
- Inadequate time horizons: the average holding period for A-shares have dropped to less than two months
- Retail investors dominate: responsible for c. 90% of daily transaction volumes, their decisions are often driven by non-fundamental factors.

These inefficiencies appear structural, hence the asset class should continue to offer outsized return potential for skilful managers with patient capital.

**Outlook**
We continue to find great companies at bargain prices in Greater China. We are accepting new investors at present.

Warm regards,

David Krige

# Q2 2015 LETTER

**Regulatory information and risk warning**



**Disclosure**

[1] Performance is for an investment made at the fund's inception; individual investors might experience different performance. MSCI Golden Dragon Total Return Index includes net dividends reinvested. Source: Charter Group Admin, Bloomberg, Cederberg.

[2] Peer group is Bloomberg universe of funds with Greater China geographical focus. Source: Bloomberg, Cederberg.

[3] Category definitions as per Cederberg.

[4] Source: Cederberg.

[5] Portfolio characteristics are quoted as of 30 June 2015. Source: Bloomberg, Cederberg.

[6] Upside Capture is calculated by dividing the fund's average NAV return during months in which the index had a positive return by the average index return during those months. Downside Capture is calculated by dividing the fund's average NAV return during months in which the index had a negative return by the average index return during those months. Source: Cederberg.

[7] Source: Cederberg.

Sources for all other figures quoted in this letter are available upon request.

Investors should note investment involves risk. The price of units may go down as well as up and past performance is not indicative of future results. Investors should read the Fund's Offering Memorandum for further details and risk factors, in particular those associated with investment in emerging markets. Information in this report has been obtained from sources believed to be reliable but Cederberg Capital does not guarantee the accuracy or completeness of the information provided by third parties.

**Cederberg Capital UK LLP**

26 Throgmorton Street

London EC2N 2AN

Tel. +44 207 871 7228

**Cederberg China**

Suite 406, Reith Centre, 9030 Shennan Boulevard

Shenzhen 518053

Tel. +86 755 8669 2456

For more information please contact info@cederbergcap.com

www.cederbergcap.com