Heijin Capital

HEIJIN CAPITAL BI-WEEKLY INVESTMENT COMMENTARY

January 13th – January 29th 2019

Heijin Capital

Investment Commentary
January 13th – January 27th 2019

Global Portfolio Holdings Weekly

Executive Summary

→ President Trump agreed on Friday (25/01) to reopen the federal government for three weeks while negotiations continued over how to secure the nation's southwestern border, backing down after a month-long standoff failed to force Democrats to give him billions of dollars for his long-promised wall.

→ With the consumer accounting for 70% of GDP, the very healthy labor market continues to set a solid foundation for the economy. Initial jobless claims fell below 200,000 last week, the lowest since 1969. This aligns with the unemployment rate near a 50-year low and wage growth tracking at the best levels in more than a decade. Economic momentum has waned a bit, but active labor market data highlight a view that we are not rapidly approaching a recession, at least for the moment.

→ Data out of China showed that the world's second-largest economy grew by 6.6% for 2018, the slowest year of growth since 1990. This added to fears of a broader global economic slowdown that has contributed to the recent market volatility. Weaker growth in China also fanned the trade war fears, suggesting that the tariff tensions between the U.S. and China are starting to take a deeper bite. Global markets initially reacted negatively to the news, but negotiations are slated to take place this week, offering the markets some potential for progress.

INDEX	CLOSE	WEEK	YTD
Dow Jones Industrial Average	24,737	0.1%	6.0%
S&P 500 Index	2,665	-0.2%	6.3%
NASDAQ	7,165	0.1%	8.0%
10-yr Treasury Yield	2.75%	-0.03%	0.07%
Oil ($/bbl)	$53.57	-0.4%	18.0%
Bonds	$106.68	0.3%	0.2%

Market Summary & Strategy

FX Markets

Thai Baht, a tale of two cities.

The major currencies have had a turbulent year at best, with fears of Brexit, trade wars and unstable economies threatening the Eurozone. However, this has turned investors into the minor currency market, allowing such currencies to have stellar performances. The strongest of which is the Thai Baht, which climbed a staggering 5.4% against the dollar in the past six months.

So why this spike in the strength of the Baht?

Thailand's comparatively large foreign currency reserves (which reached an all-time high of 215614.70 USD Million in March of 2018) has allowed the country to absorb much of the turbulence in the foreign exchange markets, in particular, the weakness of the dollar, exacerbated by the US Federal Reserve's recent dovish tilt, subsequently allowing the baht to remain stable. Moreover, Thailand has been able to maintain a current account surplus (1632.47 USD Million in November of 2018). This, in addition to the dollar's recent weakness, the baht has been able to make this rather remarkable climb.

A comparatively flourishing economy and a strong currency, why is this bad for Thailand?

The Thai economy revolves around its ability to export at competitive prices, moreover, in South-East Asia's second-largest economy, export revenue accounts for over 2/3rds of total GDP. Thus it is no surprise that as the baht experienced its dramatic rise, their exports took a similarly dramatic slump. More worryingly perhaps, is that the baht looks to continue this strength throughout the year, with expected GDP growth for 2019 at 4%. Despite this, the central bank seems to be taking care of it, with experts stating it would be unlikely for Thailand to adjust its benchmark IR following the .25% rate hike from 1.5% in December. The Bank of Thailand is attempting to subdue the build-up of risk in the financial sector through this, as the current economic strength has caused a huge inflow of hot money into the bond market. A lot of EMs have had to hike their rates immensely to levels almost never seen before to attract this "hot money" and hope that their currency will appreciate and not be eaten up by (hyper) inflation. Turkey has done this, and their rates stand at ~24%. However, this is not the issue for Thailand, the strong baht is causing the baht to fall short of target inflation rates, adversely affecting this export-driven economy.

Despite the recent fanfare surrounding the currency, we are bearish on the Baht, and the Thai economy as a whole. As previously stated the Thai economy relies on its ability to export goods and services in large quantities and at competitive prices. However, the beginning of a global downturn is beginning to rear its ugly head around the globe, in particular, China. Unfortunately for Thailand, China their largest single consumer, who is responsible for 12% of the exports, have already begun to reduce their demand. As China's, euphoric growth since the turn of the century is begging to come to a rather abrupt end. Whatsmore, Thai exports tend to be on the lower end of the value-added scale, as they are unable to compete with their neighbors at the higher end of the market ie. tech. Therefore, despite their raw material being slightly cheaper, this has not been

enough to offset the increase in relative price of their exports caused by the strength of the baht, damaging their competitiveness and, of course, their exports.

To conclude, Heijin is leaning towards a short position on the baht, despite the recent hype towards the currency. The reliance on the Chinese economy to provide its growth means that the Thai economy is at the mercy of the Chinese market. Thus, due to our bearish outlook on the Chinese market, by knock on effect we are bearish on Thailand, and subsequently their currency by the end on 2019.

Commodity Markets

The Future of LNG

Today, the United States is the world's most significant producer of natural gas. Natural gas is an essential energy source for the U.S. and the world. Supplying nearly 1/3 of the United States' primary energy it is the main heating fuel for approximately half of U.S. households. While the majority of natural gas is delivered in its gaseous form via pipeline in the United States, the growth in the international market for natural gas has given rise to the use of natural gas in a liquefied form, or LNG.

How LNG works

Liquefied natural gas (LNG) is natural gas that has been cooled to a liquid state, at about -162° C (-260° F), for shipping and storage. The volume of natural gas in its liquid state is about 600 times smaller than its volume in its gaseous state, which not only decreases the transportation costs but also ensures that it is possible to transport natural gas to places pipelines do not reach.

Liquefying natural gas is a way to move natural gas long distances when pipeline transport is not feasible. Markets that are too far away from producing regions to be connected directly to pipelines have access to natural gas because of LNG. In its compact liquid form, natural gas can be shipped in special tankers to terminals around the world. At these terminals, the LNG is returned to its gaseous state and transported by pipeline to distribution companies, industrial consumers, and power plants.

In 2017, the U.S. exported over 700 billion cubic feet (Bcf) of natural gas in the form of LNG in large LNG tanker ships, along with a small quantity shipped by container or in trucks. In total, as of March 2018, U.S. LNG has been delivered to 27 countries on five continents, and the list of destinations will continue to grow. The U.S. also still imports some LNG, mostly to New England, a region of the country constrained by limited pipeline and storage capacity.

Global LNG Demand Outlook

According to Bloomberg's 2H Global LNG Outlook, imports of LNG will set a new record this year on the back of a robust 8.5% growth - demand will reach 308MMtpa (Million Metric Tonnes per Annum) this year, up from 284MMtpa in 2017.

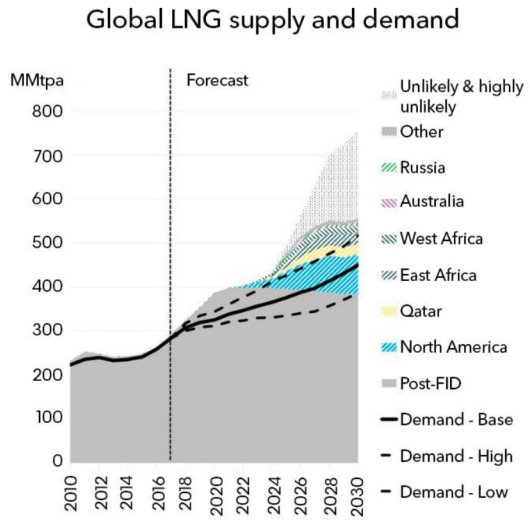
Half of the 24MMtpa of growth will come from China and the remainder mainly from Japan, South Korea, and India. The anticipated global supply surplus is likely to be modest and brief over 2020-21. The use of LNG in the industrial and transport sectors in Asia, where environmental concerns are on the rise, is likely to push up gas demand. By 2030, 450MMtpa of LNG will be needed, driven by Asia, which accounts for 86% of total growth. Demand growth will slow significantly in 2020 when China starts to receive Russia pipeline gas and Japan's ninth nuclear plant restarts. However, after that demand growth is expected to recover and remain steady with South and Southeast Asia becoming the key drivers.

However, European LNG demand is expected to fall, mainly due to the introduction of renewable energy & LNG alternatives in the coming years. John Twomey, head of European gas analysis, said: "The growth of renewables and batteries will marginalize gas-fired generation in the European power system. This will restrict the growth of LNG imports, despite declines in Dutch and Norwegian gas production. Europe will limit its reliance on Russian pipeline gas imports.

The Supply Side of LNG

Rising oil prices and surging LNG demand in North Asia in the past year have reignited developer investment in LNG supply projects. Around 27 LNG projects are now targeting final investment decisions (FIDs) in 2018-19.

- Only 11 projects have a greater than 50% chance of getting the go-ahead, deemed "highly likely and likely," in the next 18 months.
- An additional six projects are considered "likely" to take FID in the coming years and come online by 2030 based on our long-term likelihood assessment.
- Of all "likely and highly likely" FIDs, half are North American, with the remainder from Qatar, Africa, and Oceania.



Source: Bloomberg NEF. Note: The likelihood of a project being built by 2030 is based on BNEF's assessment of the project's regulatory stage, size, infrastructure, developers' financial strength, secured offtake contracts, sovereign risks, etc.

China's announcement of a 25% tariff on U.S. LNG imports complicates the already difficult process of making an FID for U.S. projects. The rift gives room for non-U.S. projects to move in.

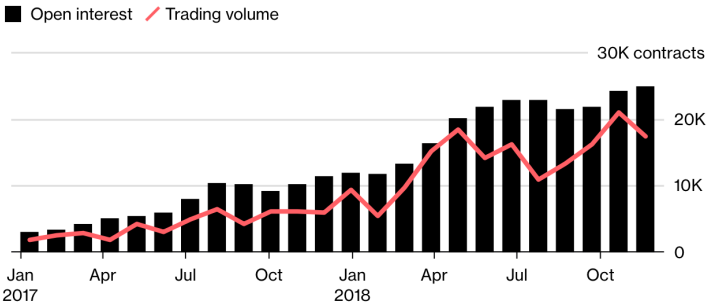
Introduction of LNG Futures

Derivatives represented about 2% of global LNG production at the beginning of 2017 as a collection of contracts around the world struggled to gain popularity. But by the end of 2018, volumes had grown to almost 23%, led by a growing Intercontinental Exchange Inc. contract based on S&P Global Platts' Japan-Korea Marker (JKM) spot price assessments.

There are now at least six derivative contracts for LNG, the most established of which is by far ICE's Japan-Korea Marker (JKM), launched in 2012. More than 17,000 contracts traded in December, a 10-fold increase from January 2017. The next most active is CME Group Inc.'s futures contract, also based on S&P Global Platts' JKM assessment. Its monthly volume peaked in November last year at 3,335 contracts.

Bright Futures

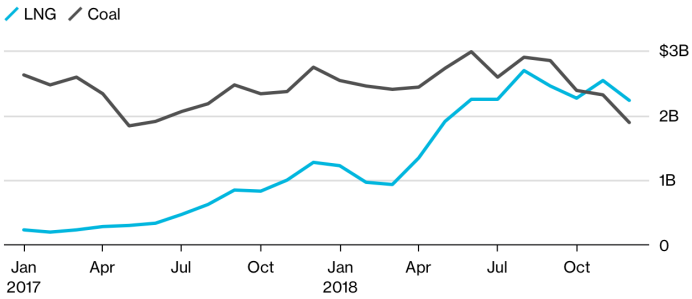
JKM LNG derivatives trading is taking off as more cargoes are sold on a spot basis



Source: Intercontinental Exchange Inc.

The Future is LNG

More money is now tied up in LNG futures than in coal



Source: Intercontinental Exchange Inc.
NOTE: Aggregate value of open interest in Newcastle coal and JKM LNG

ICE JKM is still much smaller than other global oil and gas derivative exchanges. The open interest (or the outstanding dollar amount at the end of the day) accounted for about $2 billion at the end of 2018, compared with $36 billion for U.S. natural gas and more than $100 billion for Brent oil, according to Bloomberg estimates.

However, LNG has already managed to overtake one energy derivative: coal. The rivarly of the two fuels can also be seen in the real world, where coal is often competing for space in power plants where LNG and NG are a dominant source of production.

Global Macro

The Ticking Time-Bomb: Leveraged Loans

The low interest rates in the past decade have significantly shaped the current economic situation we live in. One of the biggest changes for investors in general was that bank deposits or treasury bonds had very low returns after the crisis, often even lower than the inflation. In consequence to these low returns due to the loose monetary policy, investors of all types started seeking for investment opportunities with a higher yield. Given the economic expansion after the Great Recession, many investors were quite confident about the future of the economy and thus ready to invest in riskier high-yield debt. Most always, these investors had two options of investing into high-yield debt: high-yield bonds and leveraged-loans.

Although investing in both, high-yield bonds and leveraged-loans, is essentially borrowing money to companies below investment grade (mostly startups and cash invested companies), the details made leveraged-loans much more interesting to investors at that time. High-yield bonds, or junk bonds, have predefined interest rates, the principal is paid at maturity and are issued as securities on bond markets, which is very costly. For investors after the Great Recession, junk bonds were a not very interesting investment, because they expected the Fed to raise the interest rate, but since bonds have fixed interest rates, the premium on the risk-free rate for the same risk would decrease with every interest hike by the Fed.

Loans, on the other side, are taken out by a bank, have variable interest rates and the principal is paid in installments. The variable interest rate is most always calculated by adding a premium to the LIBOR. Since the LIBOR has a high correlation with the Fed interest rate, investors don't have to worry about interest rate hikes anymore, because interest rate of the loan would change accordingly. Since loans are most always issued by banks, investors need to rely on CLOs (Collateralized Loan Obligation) to invest in leveraged loans, which are basically CDOs (Collateralized Debt Obligations), which were the primary cause of the '08 crisis, but consisting of loans.

Given the explosion for leveraged loans since the Great Recession, whereby the size of leveraged loans doubled over the past decade to $1.2 trillion, has made it possible for companies to take out loans at increasingly favorable terms. This does not just mean that the interest rates on leveraged loans decreased, but more importantly that underwriting standards have deteriorated. According to Moody's, in the first quarter of 2018 roughly 80% of the issued loans were "covenant-light", in comparison to 25% in the years leading up to the Great Recession. "Covenant-light" bonds lack of restrictions in terms of posting collateral, payment, levels of income and traditional investor protections. Lending standards in common have significantly decreased in quality, but investors don't really seem to care. In some instances, social media accounts are listed as collateral for loan or the prohibition of moving assets out of the reach of lenders is often not included in loan documents anymore. What might happen without these investor protections is that a parent company might transfer assets from its subsidiary to itself when the subsidiary has financial problems. This implies that if the subsidiary files for bankruptcy it has less assets and the lenders receive nothing or just a very small part of their investment back when the company is liquidated.

Obviously, private equity firms suggest that investors know exactly what they are signing up for, which, however, seems questionable from our perspective.

Another problem is the high leverage ratio of most leveraged loans. In 2018, more than one third of all the issued loans had a leverage ratio 6 or higher. The number is probably even significantly higher since private equity firms, which make up a substantial part of the leveraged loan market, use so called "add-backs" when applying for loans for LBOs. These add-backs are added to the EBITDA reflecting potential cost savings and efficiency improvements in the first years after the acquisition. This makes companies appear more creditworthy and lowers thus the reported leverage. However, since these add-backs are very often unrealistically high and companies are not able to achieve the predicted improvements, the leverage ratio balloons as soon as it is evident that the reported add-backs were too high. Furthermore, the leverage ratio is even higher since the lenders buying CLOs leverage their investments, given that they consider leveraged loans as secure due to the collateral.

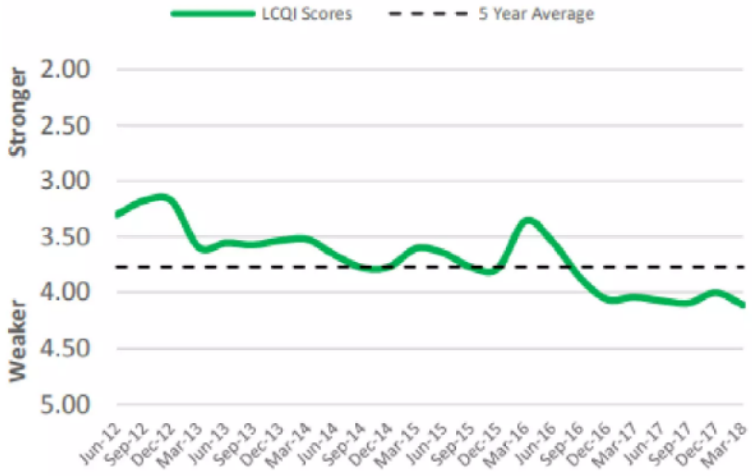
Even further problems arise from the seniority of the loans. The seniority of a loan is basically the ranking in which lenders are paid out in the case of a bankruptcy. Generally, loans are on top of the bankruptcy hierarchy, even higher than bonds. However, loans in themselves are subdivided in senior loans, which have the highest priority of being paid out, and junior loans with a lower priority. Smaller companies and startups, who basically rely just on loans, used to take on both, higher-yielding, riskier junior loans and lower-yielding, less risky senior loans. The categorization of loans was a measure of security in case of bankruptcy, since people willing to take on less risk would be the first ones to be paid out. However, many companies have noticed how careless lenders are and have therefore basically transition their entire debt to senior leveraged loans. Partly, they were able to pay down junior loans by taking on new senior loans. The arising problem is that with all the debt being redistributed to the same seniority, the risk of people who issued loans in that seniority increases because more people of the same seniority need to be paid out in case of a bankruptcy. However, many investors did not notice the transition and feel sure about their investment because they hold senior loans.

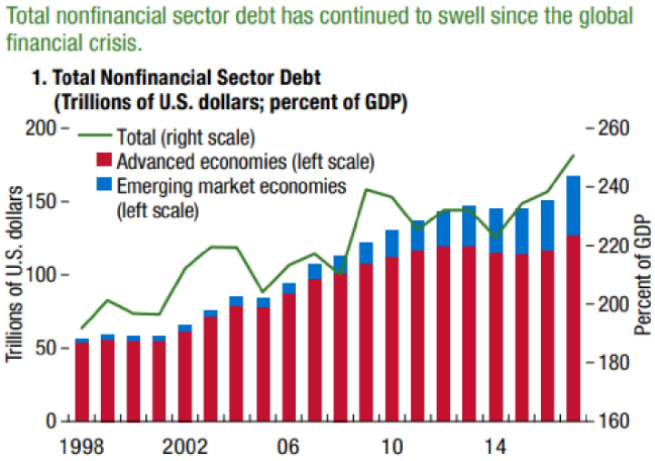
The reason, why leveraged loans can be described as a time-bomb is that lenders are most always willing to extend the lending period as long as they receive their interest payments. This means, that companies who are not able to pay down their loans are able to survive because they are basically extending their loans infinitely. This works very well while the economy is strong, profit increases and lenders are willing to accept extension. However, in times of economic downturn, companies who are not able to pay down their debt during good times will be even less likely to be able to pay their principals. However, on the other side, lenders won't be willing to extend loans anymore and given the inability to pay the principal, the companies will very likely have to file for bankruptcy.

Heijin Capital's opinion on leveraged loans is very cautious, given the huge amount of debt that has piled up in consequence of the loose monetary policies pursued by central banks. We think that the upcoming economic slowdown that is predicted for this year and beyond might be able to bring the described leveraged loans time

bomb to explode and drop the world into a recession. The past months have given us a taster of how sensitive leveraged loan investors react to market downturns and how fragile the entire sector is. However, we at Heijin are prepared for such a scenario and have already elaborated several investment opportunities. We think that one of the biggest victims of problems in the leveraged loan markets might be a drastic slowdown in the startup sector. Many investments in the startup sector are partly or entirely backed by leverage loans, which means that if investors start pulling out their money of the leveraged loan market, many startups will default and fail. Furthermore, out outlook for private equity firms who in the past years have become more and more ruthless with taking out loans will have a dark future. Another obvious victim of a downturn in the leveraged loan market are banks who issue the loans the CLOs. After having analyzed several metrics we have evidenced some similarities with the CDO problem in 2007 and we do not exclude a similar situation with leveraged loans in the near future. If our assumption of upcoming problems in the leveraged loan market in the near future are confirmed, we expect that investing in short positions on the financial sector might be a very good way to make positive returns. Furthermore, we might evaluate other opportunities, but we would like to wait for more signs of a worsening situation in the leveraged loan market.

Figure: Moody's Covenant Quality Index





Investment Analysis

How Do the Three Giants of the Fashion & Luxury (F&L) Sector Perform When a Global Slowdown Arrives?

We decided to focus on LVMH, Hermès, and Kering instead of analysing a dozen of F&L groups. These are by far the largest and can provide investors with key takeaways on how they should manage them at different stages of an economic cycle.

Short Summaries

LVMH:

Now by far the leader in the F&L with 70 houses/brands as their subsidiaries, which span across six different sectors.

- €42.6 billion in Revenue (2017)
- €5.1 billion in Group Net Profit (2017)
- 4370 stores worldwide

Main Brands:

1. Wine & Spirits: Dom Perignon, Krug, Ruinart (high growth), Hennessy, Moët & Chandon, Veuve Clicquot, Belvedere, and Château Cheval Blanc to name a few.

2. Fashion & Leather Goods: Louis Vuitton, Christian Dior, Loro Piana, Emilio Pucci, Berluti and many more.

3. Perfumes & Cosmetics: Guerlain, Acqua di Parma, Parfums Christian Dior, Givenchy Parfums and many more.

4. Watches & Jewelry: Chaumet, Bvlgari, Tag Heuer, Hublot and more.

5. Selective Retailing: Sephora, DFS, Starboard Cruise Services and more

6. Other Activities: Cova, Cheval Blanc (Hôtel in Courchevel 1850), Les Échos, Royal Van Lent and more.

Just by looking at a brief overview it is clear that LVMH dominates this sector without any doubt, and can give investors an insight into how many different brands they are exposed to whilst being invested.

Kering Group:
Probably the closest direct competitor to LVMH with significant F&L holdings. Kering is focused on fashion & leather goods, and jewelry & watches. (2 sectors)

Main Brands:

1. Fashion & Leather Goods: Gucci, Saint Laurent (poor performance), Bottega Veneta, Balenciaga, Alexander McQueen, McQ, and Brioni.

2. Jewelry & Watches: Boucheron, Ulysse Nardin, Pomellato, Dodo, Girard-Perregaux, and Qeelin.

Hermès:
In contrast to Kering and LVMH, Hermès is not necessarily a group of brand holdings even though it owns John Lobb Bootmaker, and Saint-Louis (Crystal glass manufacturer).

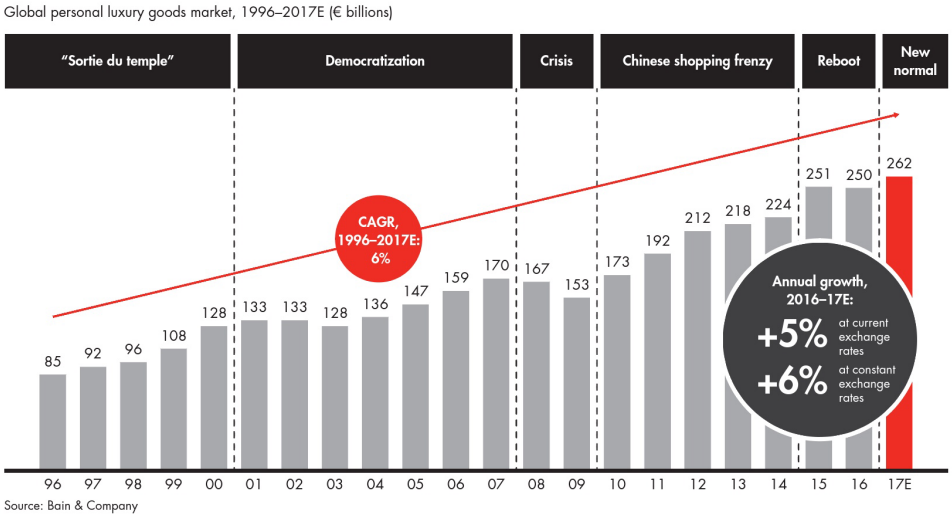
- €5.5 billion in Revenue (2017)
- €1.22 billion in Net Profit (2017)
- 212 stores worldwide (all directly operated)

Hermès is definitely a giant and punches above its weight when it manages to operate with much higher margins than LVMH or Kering are able to do. But, this is partly due to the simpler nature of Hermès.

*Bain & Company valued the Hermès Group at an astonishing €262 billion.

How do they perform in an economic slowdown?

Global performance of F&L:



The economic and market forecasts presented herein are for informational purposes as of the date of this presentation. There can be no assurance that the forecasts will be achieved. Please see disclaimer at the end of this presentation. **Past performance does not guarantee future results, which may vary.**
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It is clear from this chart that a crisis definitely harms the F&L sector, but counter to popular belief the impact of a crisis is relatively small. The 2007-09 crisis made the sector slump 10%, and in the 2000-03 crisis the sector stagnated for the most part (not even a 4% slump).

At the time of a crisis most investors tend to liquidate positions in companies that entirely depend on the F&L sector mostly due to this popular belief that when the economy contracts luxury goes down the drain as people spend less and consume with stricter budgets. However, the people driving the profits of LVMH, Kering and Hermès are mostly in the top 1% of the global earners (min. ~250k/year). And on the most part a crisis will not mean a multi-millionaire will go from shopping at Dior for his wife to Zara. Although it will reduce the frequency of purchases and the average value of purchases. On top of that the aspirational buyers tend to cut back on consumption on a big scale when a crisis comes and this is what hurts these F&L majors badly. This is especially the case when you have economies like China and India where a lot of the young population is living on borrowed money to be able to dress in these upmarket brands. Thus, when credit crunches arrive they go running out.

In order to get a view on how these F&L majors performed or behaved pre and post the 08 crisis we went through their respective annual reports from 07, 08, 09 as well as reports made on the industry as a whole by Bain & Company, McKinsey, and Deloitte.

1. LVMH, Kering and Hermès all had incredible results pre-08. In 07 growth was in the double digits. And then from Q3 2008 that's when all three started mentioning a significant downturn in sales and shrinking growth. It is only in Q4 2009 that these F&L majors were citing hope of a brighter future. However, even 2009 was painful for LVMH where Wines & Spirits dropped by 12% and Watches & Jewelry by 13%. In wines and spirits their was a significant decline in the consumption of champagne and even the rise in spirits did not offset the losses. For Kering, in 2009 revenues were down >4% in comparison to 08. But for Hermès the 08-09 was not as grim, as they actually experienced an increase in revenue and not even a 1% decline in profits.

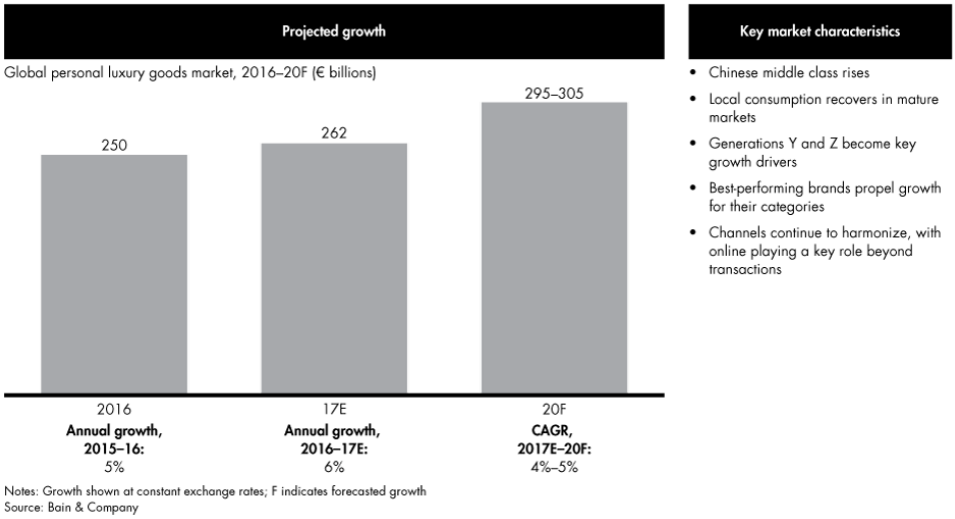
2. In the 2000-03 and 2007-2009 both Kering and LVMH experienced drawdowns >50% in terms of their share price whilst Hermès had a drawdown of barely 25%. This is reflected in their results. But are these drawdowns justified considering that the F&L dropped 10% and companies themselves dropped by 1-15% in revenues? The answer is yes, but 50% is exaggerated. The issue is that the market will tend to take most assets down along with it no matter how safe or sustainable these assets may be. This makes F&L equities great to allocate to when significant economic slowdowns appear and their shares slump heavily.

3. Today China accounts for 1/3 of the global luxury demand and 46% of Chinese consumers are planning on spending more this year on luxury goods. This is even when they are aware that a global trade war and economic slowdown could harm their incomes. However, a survey result can change rapidly since most people do not care about an economic slowdown or trade war until they actually get salary cuts and their cost of living rises.

4. Bain & Company forecasts that by 2025 the Chinese will account for 45% of the expenditure in the F&L sector. And UBS expects a "soft landing" in 2019 from 15% growth to 10% growth. Despite this LVMH already reported a significant drop in revenues from the Chinese where growth went from the high teens to low teens. On top of that, the Chinese by 2025 will be spending 50% domestically and not abroad thanks to a weakening yuan and more favourable repatriation laws.

5. For now, valuations amongst the three majors are fairly exaggerated considering the grim outlook. But they all took a beating of at least 15% in late 2018 when the market expressed some concerns on growth, which makes them slightly more attractive to hold.
6. Bain & Company still keep a strong outlook and also make note of how resilient Hermès is even during the tough times. But this can quickly change - only a handful of events can cause a big downturn.

Figure 15: The outlook for the luxury market is positive through 2020, with 4%–5% growth per year



Notes: Growth shown at constant exchange rates; F indicates forecasted growth
Source: Bain & Company

7. Today we would steer clear of the three majors or only keep Hermès if we were invested. But, when the crash comes these are incredible opportunities to acquire shares on the cheap in terms of valuations and dividends. From our research companies with high ROCEs recover well out of a crash, and for example with Hermès it has a 57% ROCE - definitely something we will hold onto.

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