Heijin Capital

HEIJIN CAPITAL BI-WEEKLY INVESTMENT COMMENTARY

October 7th 2018 – October 21st 2018

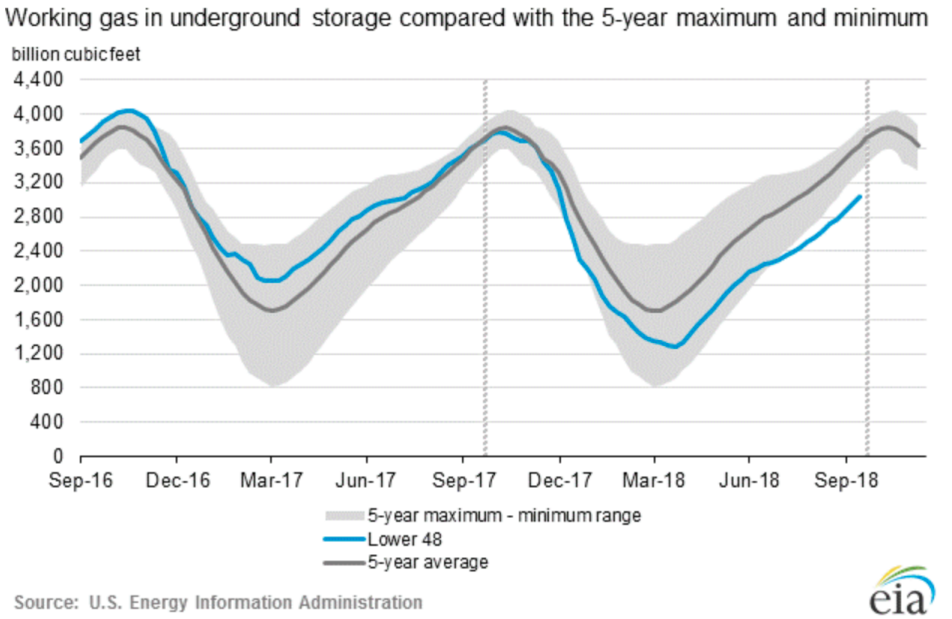
Global Portfolio Holdings Weekly

Executive Summary

- Mortgage rates have jumped to 5% this week (the highest level seen since 2007). It is now key to begin reducing exposure to REITs and Homebuilders as they are the first to suffer (the sector rotation from asset managers is punishing the tech sector as well).

- Commercial debt has never risen this fast since 2007/8. This is incredibly worrying as corporations have already taken huge advantages from the 0% interest rates and have borrowed heavily via Junk Bonds (the Junk Bond and IG Bond spread is at 1.68% now, which is showing that investors are willing to take risks for only a slightly better return).

- WTI Crude Oil slumps this week after a surprise increase in storage numbers. In fact, this inventory announcement took oil down from $75/ppb to $69/ppb and it entirely ignored the potential risks that could arise from new tensions between the U.S. and Saudi Arabia after the journalist incident. On the flip side, Natural Gas reserves came in at an unexpectedly low level, which spurred a significant rally. Along with power station outages around the country there is now heavy pressure on NG heading into the Winter with inventories at their lowest levels since 2005.



Note: The shaded area indicates the range between the historical minimum and maximum values for the weekly series from 2013 through 2017. The dashed vertical lines indicate current and year-ago weekly periods.

Heijin Capital

Investment Commentary
October 7th – October 21st 2018

Market Summary & Strategy

Is JC Penney next to collapse?

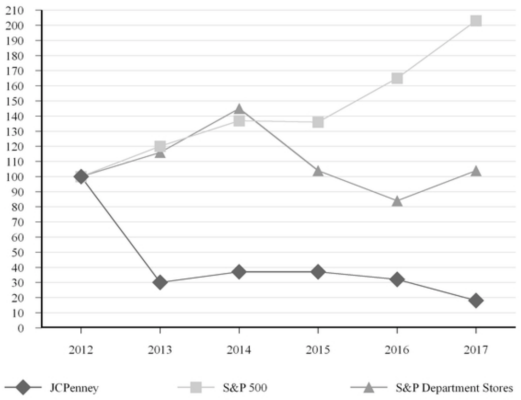
On Monday, Sears filed for Chapter 11 bankruptcy protection, announcing that it would be closing 142 Sears and Kmart stores. The liquidation sales at those locations are set to begin immediately. The bankruptcy filing comes after multiple years of falling sales. "Over the last several years, we have worked hard to transform our business and unlock the value of our assets," said Eddie Lampert, the CEO of Sears. "While we have made progress, the plan has yet to deliver the results we have desired, and addressing the Company's immediate liquidity needs has impacted our efforts to become a profitable and more competitive retailer." Lampert proceeded to step down as CEO on Monday but will stay on as chairman of the company's board.

PEER GROUP: Multiline Retail

Ticker	Company Name	Recent Price ($)	Market Cap ($M)	Price/ Earnings	Net Sales TTM ($M)	Net Income TTM ($M)
JCP	**PENNEY (J C) CO**	**1.81**	**570**	**NM**	**12,338.00**	**-53.00**
JWN	NORDSTROM INC	59.29	9,994	19.63	15,959.00	513.00
M	MACY'S INC	32.14	9,866	5.94	25,402.00	1,666.00
FRED	FREDS INC	2.56	95	NM	1,759.48	-138.52
TGT	TARGET CORP	82.80	43,582	14.50	73,991.00	3,098.00
SHLD	SEARS HOLDINGS CORP	0.34	37	NM	14,109.00	-1,308.00
DLTR	DOLLAR TREE INC	79.51	18,914	11.04	22,756.50	1,714.40
BIG	BIG LOTS INC	41.79	1,686	10.74	5,243.04	164.60
DDS	DILLARDS INC	69.98	1,642	7.92	6,498.12	249.78
TUES	TUESDAY MORNING CORP	3.16	145	NM	1,006.33	-21.94
KSS	KOHL'S CORP	70.82	11,807	12.38	19,886.00	953.00

The peer group comparison is based on Major Department Stores companies of comparable size.

Heijin Capital has had a bearish outlook on the retail industry since the start of the year, in particular JC Penney, which we have been allocating short positions on since January 2018. J C Penney saw a increase in short interest in the month of September. As of September 28th, there was short interest totaling 133,740,330 shares, an increase of 2.9% from the September 14th total of 129,968,341 shares. Based on an average daily volume of 13,301,992 shares, the short-interest ratio is currently 10.1 days. Approximately 43.6% of the company's shares are sold short.



JC Penney has experienced a steep decline in earnings per share in the most recent quarter in comparison to its performance to the same quarter a year ago. During the past year, JC Penney reported weak results of $ -0.35 versus $ -0.01 in the prior year. For the next year, the market is expecting a contraction of 152% in earnings ($ -0.89 versus $ -0.35).

The debt-to-equity ratio is significantly higher than that of the industry's average (3.47) implying increased risk with the management of debt levels

within the company. Along with this, the company manages to maintain a quick ratio of 0.09, which is a clear demonstration that the company is unable to cover short-term cash needs. Net operating cash flow has decreased to $219.00 million (or 45.52%), if compared to the same quarter last year. In addition, when comparing to the industry average, the firm's growth is significantly slower.

Despite any short-term fluctuations, we have only bad news to report on this stock's performance over the last year: it has tumbled by over 50%, worse than the S&P 500's performance. Consistent with the plunge in the stock price, the company's earnings per share are down 113.33% compared to the year-earlier quarter. However, in one sense, the stock's sharp decline last year is a positive for future investors, making it cheaper (in proportion to its earnings over the past year) than most other stocks in its industry. But due to other concerns, we feel the stock is still not a good buy right now.

If JC Penney doesn't manage to deliver real progress during the holiday spending blitz, we suspect already-fragile investor confidence is going to diminish very quickly. Expectations for major retailers will be running high. Any chain that doesn't perform well will face tough questions about why they couldn't score with consumers at such an advantageous moment. Plus, it's clear that two of J.C. Penney's closest rivals, Macy's Inc. and Kohl's Corp., are on the upswing, demonstrating that improvement is achievable now, even in the challenged department-store format.

Other problems department stores are facing:

- Department stores are being forced to face up against giants like Amazon and Walmart, and many are coming up short in their e-commerce offerings.

- Macy's, JC Penney, Sears, and Lord & Taylor are all closing stores.
- As a result of more shoppers turning to online stores, there's also been a decline in foot traffic to malls.
- Stores like TJ Maxx and Marshalls carry brands like Michael Kors, Tommy Hilfiger, and Calvin Klein for less than department stores, so many shoppers are more likely to shop at the off-price retailers.
- The decline of the middle class has also taken a toll on department stores.
- The most successful stores in retail right now are luxury stores and budget stores, and those that depend more on middle-class spending aren't doing as well.

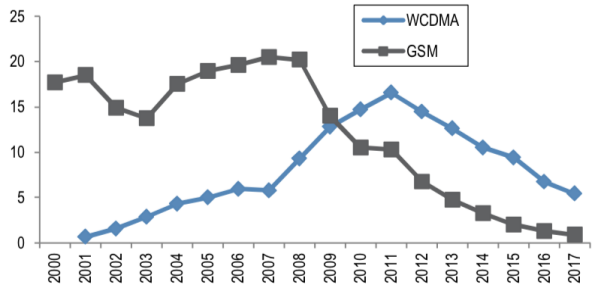
Heijin Capital will be closely monitoring how JC Penney and the multiline retail sector will deal with the influx of demand driven by the upcoming holidays, however, we are not expecting much. If these department stores are not able to come up with a "christmas miracle" this year, we have strong reasons to believe JCPenney might not be around for much longer.

Transitioning into the 5th generation

5G is the fifth generation of cellular mobile communications and the successor of the current standard 4G (LTE). The introduction of 5G fixed wireless access, which delivers wireless broadband internet connections to households and businesses, has marked the stepstone of the 5G era which is very likely to disrupt the technology sector in the near future. Unlike 4G and its predecessor 3G, 5G does not simply increase the speed of mobile broadband connections, but it enables fixed wireless access, massive machine type communications which enables massive IoT and ultra-reliable low latency communications which enables Industry 4.0. However, since it is still just the beginning of the 5G era, it is not clear how and which consumer companies will be able to monetize 5G in the best way.

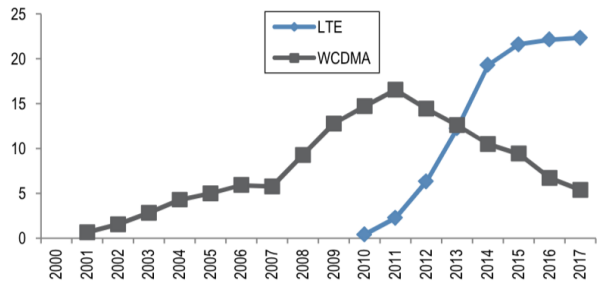
An exception to this are companies in the radio access network (RAN) market, which will benefit a lot from telcos upgrading their systems to the 5G standard. The RAN market has decreased constantly and dropped by ~18% since '14 because basically all major industrialized countries had finished upgrading their telecommunication systems to 4G by that year. However, this is a normal development in the RAN market between the releases of new network standards. An increased spending in the RAN market due to 5G has started in 2018 and is likely to continue for 2019 and 2020. The peak in spending is expected in 2020 or 2021, because the investments into 4G in development countries will not have dropped by then. After the peak it is not yet clear if the spending in RAN will decrease because of its cyclus or if 5G has introduced a structural change to the RAN market that makes the spending acyclical.

Figure 4: 2G spending held up at high level for much longer in the transition to 3G



Source: Dell'Oro

Figure 3: Spending has moderated because 3G spending decline exceeds 4G increase



Source: Dell'Oro

The biggest benefactors of the increased expenditures in the RAN market will be the chipset maker Qualcomm and the telecom equipment companies Nokia and Ericsson with a predicted 90% share of the total 5G royalties. Qualcomm has a 50% ownership of the 5G intellectual property (IP) and has announced to charge up too $15 of royalties per device sold. Ericsson and Nokia own 35% of 5G's IR and have announced to charge $5 and $3.5 respectively for every device sold. Furthermore, technological advancements have made it possible for companies like Nokia and Ericsson to maintain networks remotely instead of carriers having to send their own engineers, what will be another source of revenue for those companies.

Furthermore, companies providing the fiber backbone for the carrier sites will benefit from the transition to 5G since the increased amount of data and throughput capacities at the carrier sites will require improved connectivity. Companies like Zayo and Crown Castle are likely to have increasing demands in the coming years, however, since carriers like Verizon are also investing in building out their own fiber backbone, their revenue growth will be limited.

Some of the current roll-out-plans are:

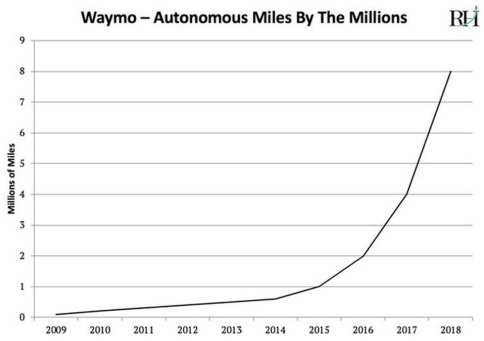
- **AT&T:** "Our millimeter wave mobile 5G trials are also going well and we're on track to launch service in parts of 12 markets by the end of this year" (Earnings conference call, 07/24/2018).
- **Verizon:** "Verizon will be the first wireless technology provider to deploy 5G residential broadband service and 5G mobile service in the United States. Home internet will begin in the four identified markets (Indianapolis, Houston, Los Angeles, and Sacramento) this year. As mobile devices become available in early 2019, Verizon plans to quickly move to be first in 5G mobile service" (Earnings conference call, 08/14/2018).
- **T-Mobile:** "Our plan continues to be to bring 5G to 30 cities in 2018, starting with New York, LA, Dallas, Las Vegas, with nationwide coverage coming in 2020. This network will utilize 600 MHz and will harness 4G and 5G bandwidth simultaneously for dual connectivity and will be ready for the first 5G smartphones in 2019." (Earnings conference call, 08/01/2018).
- **Sprint:** "Sprint's priority is mobile 5G and we expect to provide commercial services and devices by the first half 2019." (Earnings conference call, 08/01/2018). "Sprint is still planning on launching its 5G network in the 2.5 GHz (band 41) of spectrum, and is actively working with Qualcomm (its Snapdragon X50 5G modem will support the 5G NR standard on Sprint's 2.5 GHz band) and device manufacturers to launch 5G phones in the first half of 2019 alongside the network." (Sprint press release, 02/27/2018).

Heijin Capital believes that 5G will disrupt the technology sector and offer huge investment opportunities considering the predicted 5G market size of $251 bn by 2025. We think it is worth to track all the changes in this sector in the coming years, since they will play a crucial role in the digitalization of companies and the world in general by enabling the usage of IoT and Industry 4.0 on a big scale. Some of the investments Heijin is evaluating as the 5G revolution gains momentum are Nokia and Ericsson, which are the companies with the biggest exposure to the 5G market.

Exposing yourself to driverless automobiles

There are a tremendous amount of advantages by having a car that drives itself, primarily an increase in safety, as in the US alone there are around 5.5 million automobile accidents per year, with about 88 deaths per day, of which 81% are caused by human error. This statistic in itself demonstrates the advantage of a driverless car, as over 4 million of those accidents wouldn't have happened in the first place. Secondly, the time gained by drivers who instead of paying attention on driving, could pay attention to work, family or entertainment, this could save commuters worldwide over 1 billion hours everyday. Thirdly, traffic and fuel efficiency will greatly improve as traffic flow will improve. In fact, CO2 emissions produced by cars could fall by around 300 million tonnes, according to McKinsey. All these factors point driverless vehicles as the future of automobile transport.

Google, and its Waymo project are without a doubt industry leaders for driverless cars, having run a combined 8 million miles in over 25 cities, and billions in computer simulations, it also had the least accidents in California. Waymo has 3 accidents in over 350,000 miles, and GM had 22 accidents in over 132,000 miles. Waymo is also the only program to run a ride-hailing pilot in a car without a steering wheel or pedals. Uber and Tesla are also companies that are heavily invested in driverless cars, however they are a couple years behind.



However going long on Google and picking up some common stock or call options might not be the best way of producing income from this situation, this is because driverless cars could very well become an existential threat to the car industry as well. When Uber and Lyft were new some experts argued they would kill car-ownership, however this never really happened, arguably due to there hefty price tag. For Uber, the biggest chunk of the fare goes to the driver, out of the 37$ billion that went into uber last year, 30$ billion went to the drivers, over 80%. As a result Waymo could hugely undercut prices if they did not have to pay any drivers. A report by UBS driverless ride-sharing services will be 70% cheaper than Uber. Therefore instead of going for Google, the wisest decision may be in shorting automobile industry titans, such as Toyota, VW, Hyundai and GM, especially cars that are mostly driven in urban areas, where Wymo will be available. Car insurance companies will also have lower revenues, as driverless cars could decrease accidents by 90%. Companies that sell auto parts will also experience lower revenues as wear and tear will go down.

Overall this is a major opportunity which can be exploited in many ways, however it is most likely best to not get into some of the opportunities immediately, as driverless cars are not ourightly available yet, however by early 2019 Heijin predicts the market will begin feeling huge pressure from Wymo particularly.

Contact Details

Gregory Laurent Josi
Founder, Managing Partner & CIO
gregory.laurentjosi@heijincapital.com

Pasha Tinkov
Partner & COO
pasha.tinkov@heijincapital.com

John De Pauw
Partner
john.depauw@heijincapital.com

James Schofield
Partner & Head of FX
james.schofield@heijincapital.com

Moriz Martiner
Analyst
moriz.martiner@heijincapital.com

DISCLAIMER

Heijin Capital or HeijinCapital.com, is not an investment advisory service, nor a registered investment advisor, nor a capital management firm or broker-dealer and does not purport to tell or suggest which securities customers should buy or sell for themselves. The analysts and employees or affiliates of Company may hold positions in the stocks or industries discussed here. You understand and acknowledge that there is a very high degree of risk involved in trading securities. The Company, the authors, the publisher, and all affiliates of Company assume no responsibility or liability for your trading and investment results. **Heijin Capital operates as a private family fund where we oversee several managed accounts.**

It should not be assumed that the methods, techniques, or indicators presented in these products will be profitable or that they will not result in losses. Past results of any individual trader or trading system published by Company are not indicative of future returns by that trader or system, and are not indicative of future returns which be realized by you. In addition, the indicators, strategies, columns, articles and all other features of Company's products (collectively, the "Information") are provided for informational and educational purposes only and should not be construed as investment advice. Examples presented on Company's website are for educational purposes only. Such set-ups are not solicitations of any order to buy or sell. Accordingly, you should not rely solely on the Information in making any investment. Rather, you should use the Information only as a starting point for doing additional independent research in order to allow you to form your own opinion regarding investments. You should always check with your licensed financial advisor and tax advisor to determine the suitability of any investment.

Thank you for your understanding,
Heijin Capital Management

***Past performance does not guarantee future results, which may vary. The value of investments and the income derived from investments will fluctuate and can go down as well as up. A loss of principal may occur.**