

HEIJIN CAPITAL BI-WEEKLY INVESTMENT COMMENTARY

March 24th – April 7th, 2019

Global Portfolio Holdings Weekly

Executive Summary

→ **Chinese Debt Market:** Horrifying data was released from China last week in relation to Chinese corporate bond defaults, which are skyrocketing. This may be the first sign to China's weak credit markets that have been propped up for so long by the government and with the help of the gigantic shadow banking system that has been created.



→ Brexit:

The current deal was agreed between the UK and EU in November 2018, however, it has yet to be accepted by the House of Commons, having been rejected multiple times. This meant that the UK was not able to leave at the previously agreed date of the 29th March. The extension has been granted to the 12th of April, meaning that the UK will leave with or without a deal. Of course, Prime Minister May has been trying to broker a deal within the commons reaching out to opposition parties for support to pass through a deal, much to the dismay of many of her front and backbenchers. This in addition to other shortcomings on either side of the bench has resulted in many MPs resigning, or even forming a new party. The current state of Brexit is a dismal one, however, if MP can put aside party politics for the good of the country, there is still much to be salvaged.

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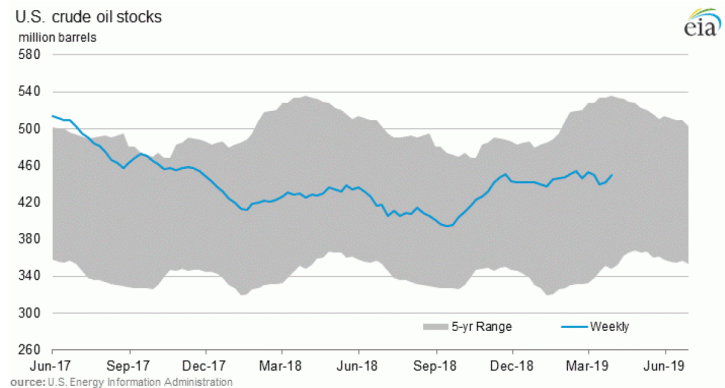
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Market Summary & Strategy

Commodities

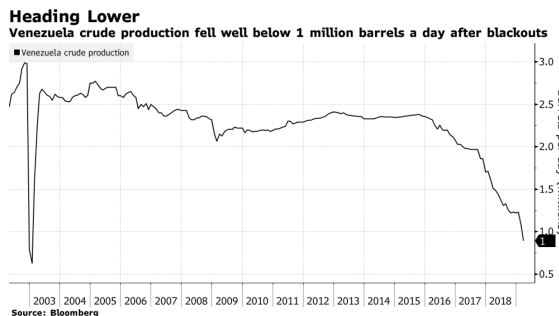
The Return of the Oil Bull

Oil prices have rallied this week, with Brent hitting an all time high for this year at \$70/barrel. The U.S benchmark (WTI) is not far behind and has reached highs of about \$63/barrel on Wednesday, April 3rd. Oil prices have jumped in 2019 following a brutal sell-off in the fourth quarter, which dragged Brent prices from a four-year high above \$86 a barrel in October to near \$50 a barrel by the end of the year. The recovery has come as Saudi Arabia has led Opec in cutting output to counterbalance for fast-growing production from US shale, while Venezuela and Iran's production has fallen sharply due to US sanctions and power outages.



Here are the key reasons for the return of oil's bull run:

1. **U.S. and China make more progress on trade deal:** President Donald Trump met with Chinese Vice Premier Liu He at the White House on Thursday as the two sides come closer to finalizing a deal that could end the trade war. The arrangement would give China until 2025 to meet commitments on commodity purchases from the U.S. and for the permission of allowing 100 percent foreign ownership for American companies operating in China.
2. **Venezuelan production falls significantly:** Estimates from earlier this week from Reuters found that March exports proved resilient, holding at just below 1 mb/d. But S&P



Global Platts estimates that Venezuela's output plunged to 740,000 bpd, falling by 360,000 bpd, following the widespread power outages. Near the Orinoco basin in the East, where four out of every five barrels is pumped, heavy tar-like oil has begun to clog pipelines and tanks after the heating system lost power. The Orinoco Belt area hasn't recovered fully from the

electricity blow and is currently producing about 300,000 barrels a day, according to Bloomberg's estimates.

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3. **E&P free cash flow hits record high:** the total free cash flow for all publicly-traded exploration and production companies hit a record high in 2018 at nearly \$300 billion, according to Rystad Energy. The profits were not anticipated as prices remain at a fraction of their pre-2015 levels. The fact that E&P companies can deliver the same shareholder returns despite much lower oil prices points to an impressive increase in profitability.

Heijin Capital's holdings in EOG Resources (NYSE:EOG) and Kosmos Energy (NYSE:KOS) have both benefited significantly from this, with the companies finishing the week up 5.43% and 9.62%, respectively.

Other interesting points affecting oil prices:

- **Solar-energy boom in Texas:** The shale drilling excitement in Texas is helping to fuel a solar boom, as drillers push up the demand for electricity. And without any incentives from the state, the dash for solar is proof that the technology competes with coal and gas on economics alone. One of the largest companies benefiting from this is a San Francisco based solar and wind energy company called Pattern Energy Group (NASDAQ:PEGI), which is up 11% on the month. PEGI is one of the largest solar providers in the Texas region. Moreover, a solar project costs about \$38/megawatt-hour in Texas, according to Bloomberg New Energy Finance, while a high-efficiency gas plant costs \$38/megawatt-hour. On top of that, solar plants can be completed in a matter of months, while gas plants may take years.
- **Norway's Sovereign Fund divesting from oil and looking for renewable opportunities:** The world's largest sovereign wealth fund—created three decades ago to safeguard and manage Norway's oil wealth for future generations—made headlines last month, when the government proposed that the fund divests from oil and gas exploration companies. Weeks after Norway's government introduced this act, the cabinet said on Friday that it will allow the world's biggest sovereign wealth fund to invest in unlisted renewable energy infrastructure. Norway is also doubling the upper limit on unlisted green energy investments from US\$7 billion (60 billion Norwegian crowns) to US\$14 billion (120 billion crowns). "The Government is now allowing for the Government Pension Fund Global to be invested in unlisted renewable energy infrastructure. The investments shall be made within the scope of the special environment-related mandates only," the Norwegian government said in a statement published on their website.

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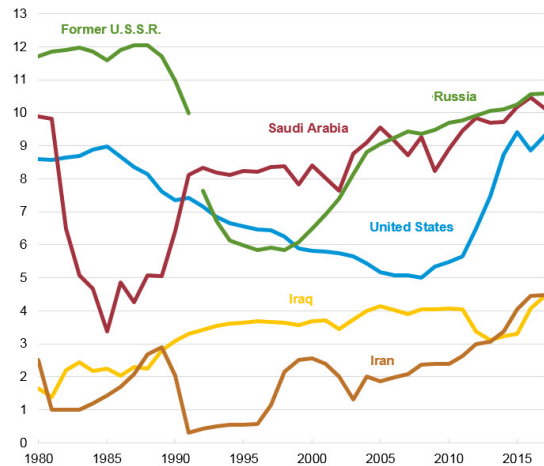
Saudia Arabia Threatening to Ditch Dollar-Denominated Trading

Saudi Arabia is threatening to sell its oil in local currencies if the US passes a bill exposing OPEC members to U.S. antitrust lawsuits. In the unlikely event Riyadh was to ditch the dollar, it would undermine its status as the world's primary reserve currency, reducing the US's rank in global trade and weaken its ability to enforce sanctions on nation states. A move by Saudi Arabia to ditch the dollar would resonate well with big non-OPEC oil producers such as Russia as well as significant consumers like China and the European Union, which have been requesting for moves to diversify global trade away from the dollar to dilute U.S. influence over the world economy.

Russia, which is subject to increasing U.S. sanctions, has tried to sell oil in euros and the Chinese yuan but the proportion of its sales in those currencies is insignificant. Venezuela and Iran, which are also under U.S. sanctions, sell most of their oil in other currencies but they have done little to challenge the dollar's leadership in the oil market. Trading in derivatives such as oil futures and options is also mainly dollar denominated. The top two global energy exchanges, ICE and CME, traded a billion lots of oil derivatives in 2018 with a nominal value of about \$5 trillion.

Saudi Arabia controls a 10th of global oil production, roughly equal to its biggest competitors - the United States and Russia. Its oil firm Saudi Aramco holds the crown of the world's biggest oil exporter with sales of \$356 billion last year. Depending on daily prices, oil is estimated to represent 2 percent to 3 percent of the global gross domestic product. At the current price of \$70 per barrel, the annual value of global oil output is around \$2.5 trillion.

Top five crude oil producing countries, 1980–2017
million barrels per day



Note: Includes crude oil and lease condensate. Ranking based on production in 2017.
Source: U.S. Energy Information Administration, International Energy Statistics, May 2018



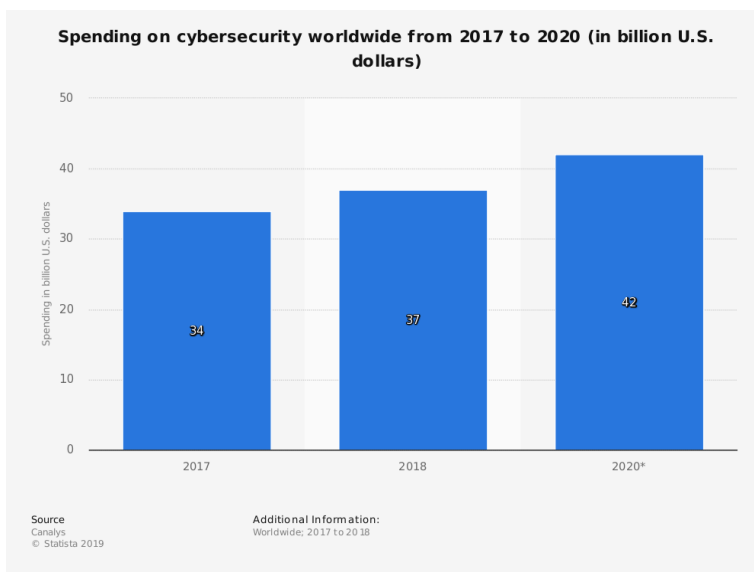
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Global Macro

Cyber Security

Cyber Security has historically been one of the most underrated issues in society. While the spending for Information Technology exploded in the past decades, spending to protect the data the IT systems contain is terribly low. For reference, in 2017 the global spending in IT was around \$3.5 trillion, but the spending in cyber security was just about \$34 billion. In other words, only about 1% of the money spent in IT infrastructure is used to protect the data at its core. One of Heijin's team members can prove the issue of cyber security, since he was able to gain access to servers containing data of an entire state in a couple of hours using no more than a laptop and an ethernet cable (The team member did not act illegally, he was contracted to conduct penetration testing on the respective infrastructure).



The companies' refraining behavior towards investing in cyber security can most empathetically be explained with people's refraining from doing backups. Most people agree on the importance of backups and understand why people should do them; however, when it comes to actually doing the backups most people are not ready to invest the necessary time and money. Only in the worst-case scenario, when people lose all their data, they actually start doing backups, but then it is too late: the data is already gone. Most companies act in a very similar way with cyber security, whereby they do not invest enough in it until it is too late. The reactive behavior lies at the core of the low spending in cyber security.

However, in recent years things seem to have changed a bit and people are increasingly concerned about data privacy and security. Moreover, security breaches such as happened to Yahoo, Equifax and Marriott had a significant impact on the companies by damaging their reputation, triggering lawsuits and lowering user's willingness to entrust them with their data. Whereas the growth in spending in cyber security was historically lower than the growth in IT infrastructure spending, the former is currently growing at a rate around 10% whereas the latter's growth is flat.

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Companies and governments seem to have finally begun taking cyber security more seriously, making it a very interesting market to invest in. Currently, the cyber security market is estimated to be worth around \$120 billion and it is said to grow to over \$300 billion, implying an increase of 150% in 5 years. This growth might finally allow cybersecurity companies to flourish and attract market capitalizations worthy the huge tasks they are assigned to solve.

Zscaler

One of the most interesting and unknown companies in the cyber security space is Zscaler. The company is specialized in the protection of companies from attacks resulting from their transition into the cloud. Generally, moving data and operations to the cloud improves security, since the cloud providers have some of the most advanced cyber security technology in the world. The strength of their security systems is proven by the government's efforts to move their data into the cloud, which they wouldn't do if they didn't trust the cloud providers. However, moving data to the cloud and making it thereby accessible from everywhere through the internet creates new vulnerabilities. Zscaler consults and implements solutions to the security risks of moving operations and data to the cloud, benefitting from both companies' push to the cloud and to stronger cyber security. Financially, Zscaler is in quite a strong position for a growing company, with sales expected to increase to grow from \$190 Million to \$290 Million during the current fiscal year. Additionally, Zscaler is expected to post its first income during the current fiscal year, with a net margin of 5.6%.

Heijin Capital believes that cyber security is one of the sectors that will continuously gain importance over time and become more and more important every year. Moreover, the transition to autonomous cars, 5G, SmartHomes, and all the technological advancements we cannot even think of now will make cyber security as important as having alarm system nowadays, if not more. Additionally, we expect governments to ramp up spending in cyber security and warfare, given that it is a far more efficient way to cause harm to an enemy than through tanks and bombs. Due to all these reasons, we are putting significant effort into finding the right allocation in the cyber security market, since we expect it to be one of the most significant sectors in the future.

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Global Macro

Bahrain, the New Jewel of the Gulf?

The Gulf nation of Bahrain has always been a front runner, having been one of the first nations to discover and refine oil. However, due to the size of their reserves, Bahrain was never able to produce and refine oil at the scale of Saudi Arabia and Kuwait. This forced the Bahrain economy to diversify, as it was not able to rely on oil revenues to prop up its economy like Saudi Arabia. Of course, now, as the markets are looking towards a fossil fuel-free future, this has proven to be a blessing in disguise for Bahrain, as it is now on the forefront of fintech in the middle east.

The Bahraini government has been establishing itself as a hub for foreign investment, inviting foreign firms to come and set up shop in their country. The Central Bank of Bahrain has created fertile grounds for a fintech boom in the near future, through their support of the deregulation of banking and the transfer of cryptocurrencies. It is no wonder that the middle east, in particular, Bahrain, has become the destination for up and coming fintech firms. With estimates of well over 2bn\$ in private funding of the next decade in the region, compared with less than a tenth of that in the previous 10 years. What's more, Bahrain's infrastructure set an example for the entire middle east, taking pole position in the race for 5G, with aims to reach 95% of households and 100% of people by the end of 2019. In addition to this, Bahrain is launching a 100% digital tax refund system later in 2019. This means that tourists will be able to reclaim VAT on goods purchased in the Kingdom quickly and with great ease. This should bolster the already large tourism sector of UHNWI to the kingdom due to the Bahrain Grand Prix, which has become one of the favorite tracks for spectators and racers alike. The amalgamation of all these factors leads the team at Heijin to have an extremely active interest in the country and its very bright future.

So, which firms should one look out for?

- Ericsson (STO: ERIC-B) are in joint venture with the Bahraini firm Batelco, to deploy the 5G technology across the country and improve day to day operations to switch from 4G with no hiccups. What's more, Ericsson is a classic value play. With their emphasis on organic growth, heavy investment into R&D, cost efficiency. It is well on its way to surpass its targets for 2019.

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Investment Analysis

What happened to Biogen?

We tend to stay away from pharmaceutical equities as much as possible due to their unpredictable nature, which even in big pharma can seriously erode shareholder value. Last month this view was once again proven to be correct after Biogen's 30% plunge (i.e. >USD18 billion loss in market cap.) due to the announcement it made on the cancellation of two Alzheimer drug trials. This caused the share price to enter a territory of extreme negativity, which we like speculating in since the risk/reward ratio is significantly more favourable when compared to other scenarios. Biogen is now seriously below its fair valuation and we have already formulated a strategy in order to optimise the potential returns.

Summary of Biogen (NASDAQ:BIIB or SWX:BIIB - Switzerland listing):

Biogen is one of the leading corporations in the pharmaceutical sector with a market cap of USD48 billion and operating mainly as a drug manufacturer.

→The company is focused on discovering, developing and delivering worldwide innovative therapies for people living with serious neurological and neurodegenerative diseases, including in their core growth areas of multiple sclerosis (MS) and neuroimmunology, Alzheimer's disease (AD) and dementia, movement disorders, including Parkinson's disease, and neuromuscular disorders, including spinal muscular atrophy (SMA) and amyotrophic lateral sclerosis (ALS).

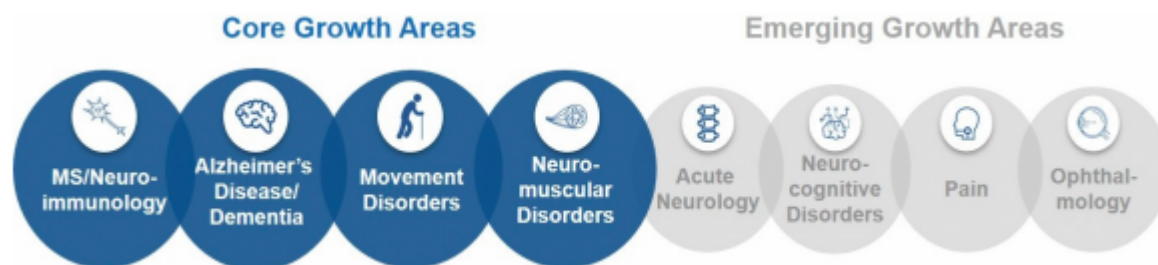
→ The company also focuses on discovering, developing and delivering worldwide innovative therapies in their emerging growth areas of acute neurology, neurocognitive disorders, pain and ophthalmology.

What happened with the Alzheimer's Drug?

For Biogen the Alzheimer drug was part of the core growth areas for them, as shown in the diagram below. Losing one large component of the core growth areas took investors and analysts by surprise, which led to a series of downgrades and a plummeting share price. Since after all the analysts had discounted the estimated potential future earnings of the 2 cancelled drugs to present time. We suspect that the overreaction and slightly irrational selling off was due to the fact that the 2 cancelled drugs were in stage three of development. And in the pharma world, stage three is close to the final stage (see diagram 2).

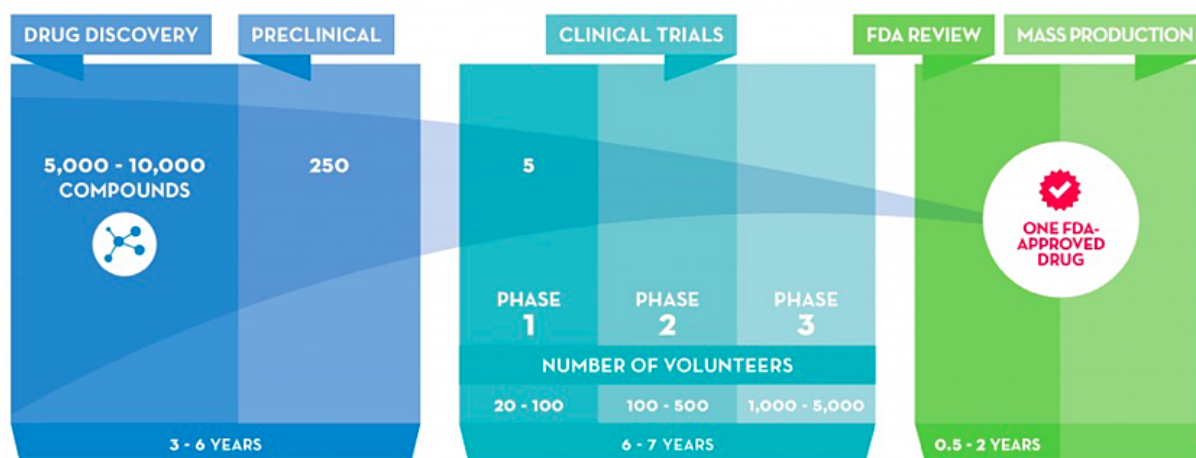
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(Diagram 1)/Biogen 2018 Annual Report

THE STAGES OF DRUG DEVELOPMENT



(Diagram 2)/Aurous Healthcare

According to reports, the decision to stop the drug from going any further was made by an independent committee, which conducted a futility analysis and determined that the drug had little chance of passing the next trials. Biogen was in a partnership with a Japanese firm called Eisai, but the BAN2401 Alzheimer drug they developed failed 12 months of tests even after previous clinical results instilled a sense of 'hope'.

The Aducanumab (Alzheimer drug that was stopped) went through a few trials in phase 3, but the results ended up being disappointing. Following the cancellation it was stated that Alzheimer's is still incredibly complex to resolve and that further neuroscience research needed to be carried out. Despite this Biogen is not giving up and they will proceed with Eisai on the BAN2401.

In terms of competition, all the other biopharma majors stopped trying to develop Alzheimer drugs after they faced negative results from clinical trials. Roche Holding AG also cancelled its drug two months ago, which actually made its share price rise by >2%. However, Roche's partner AC Immune lost 65% of its market value as it was much more reliant on this drug being a success. Roche and Biogen were both developing drugs that had the objective of destroying the amyloid, which was presumably one of the key causes for Alzheimers.

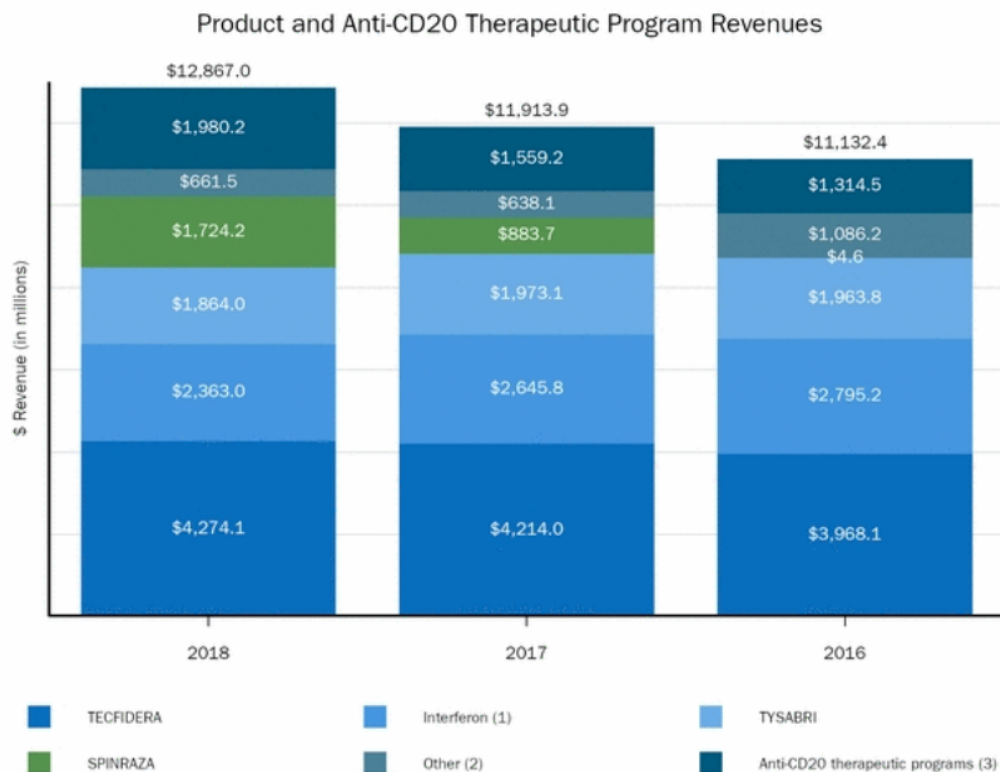
Overall, the Alzheimer's market size for drugs is enormous, even in the U.S. alone where there are ~5.7 million people with it and the figure is projected to grow to 14 million by 2050. Thus, all in all a big blow to Biogen's revenue potential projections that it had outlined a couple years ago.

Why did Biogen fall 30% if it is only one drug?

In principal, Biogen fell this much due to the news being a surprise for investors and because Biogen had struggled to improve its pipeline and this should have been the solution.

Firstly, from our research we concluded that it should not have been a surprise and that investors were just misinformed about this drug and the actual likelihood of success it had. In truth, it does not take a rocket scientist to suspect it will be a failure after every single other biopharma major had released negative results and cancelled their respective developments of a drug for Alzheimer's disease. This is especially the case when Roche cancelled an almost replica drug 60 days prior. Either investors were blind to see this or they just did not want to face reality, which is probably the case. Even so, the 30% fall was irrational and it leaves the stock at an attractive level.

Secondly, Biogen is facing some patent issues with competitors for their Multiple Sclerosis (MS) drugs, which are the "meat" of their cash flow. I.e. ~80% of Biogen's revenues are from MS drugs. This is what worries investors and analysts the most (with good reason). However, Biogen still dominates in this space, but analysts are still worried and suggest that Biogen should carry out 'value-adding' acquisitions instead of spending billions on failing drugs. We disagree with this since the funds could be allocated to improve Biogen's key revenue streams and make sure no other key growth area is erased.



(Diagram 3)/Biogen Annual Report 2018

Our Strategy with Biogen:

Biogen is now trading at an attractive price even when compared to its competition. The 13 major competitors of Biogen (ones which have a higher market cap only) currently have an average PE of 26. Thus, even if Biogen were to approach a level slightly lower since they are less diversified, they should still be trading in a range of USD350-400 (exactly where it was before). This is despite the loss of a drug that was hoped to be the next blockbuster in the pharma world. After all, Biogen has plenty more drugs in their pipeline whether they are in the core growth area or emerging growth area.

We believe that in order to optimise returns with Biogen there should be a mix of common stock and a couple batches of (buy-to-open) call options. To be more prudent with options we are looking at the calls with strike prices ranging from USD275-320 expiring July 19, 2019. By utilising the Black Scholes model we found huge price inefficiencies, but these were quickly corrected and led to some options we selected rising as much as 49% on Friday alone. Even so the spreads are enormous, which could create interesting opportunities. Finally, the call option contracts with strike prices >USD300 are still trading at attractive prices with at least 30% increase in potential. We will monitor the options market for Biogen closely on Monday and allocate accordingly.

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