April 17, 2018

Dear Clients, Partners, and Friends,

The results for South Ocean Management's Delaware LP, Hong Kong Partners' L.P., before incentive fees, were as follows:

	Mar 2018	Year-to-date
Hong Kong Partners LP	-3.1%	-1.6%
Hang Seng Index	-2.7%	3.1%
Hang Seng Small Cap Index	0.5%	6.3%
MSCI HK Small Cap Index	-9.0%	5.3%

Partners' NAV $3.0805 after management fee and provisions, but before annual incentive fees of 15% on appreciation.

South Ocean Management's portfolios of small/mid cap, Hong Kong-listed companies with earnings geared towards China, lagged in 2018's first quarter.

Fears of a US-China trade war escalated late last month causing investors to become skittish in Hong Kong. Stocks fell sharply after a steep sell-off in US technology shares as Washington was reported to be considering a crackdown on Chinese investment in "sensitive" US technologies.

For the year, the top returns of the large cap index have been primarily in three sectors: technology, real estate/finance and consumer related industries:

Name	YTD %	
HANG SENG INDEX	0.87	
SUNNY OPTICAL	43.9	Tech
SINOPEC CORP	24.6	Energy
CHINA RES LAND	23.9	Real Estate
MENGNIU DAIRY	20.0	Consumer
GALAXY ENT	16.5	Consumer
CCB	12.8	Finance
BANK OF CHINA	10.9	Finance
SWIRE PACIFIC A	9.9	Real Estate
CHINA OVERSEAS	8.7	Real Estate
ICBC	8.4	Finance

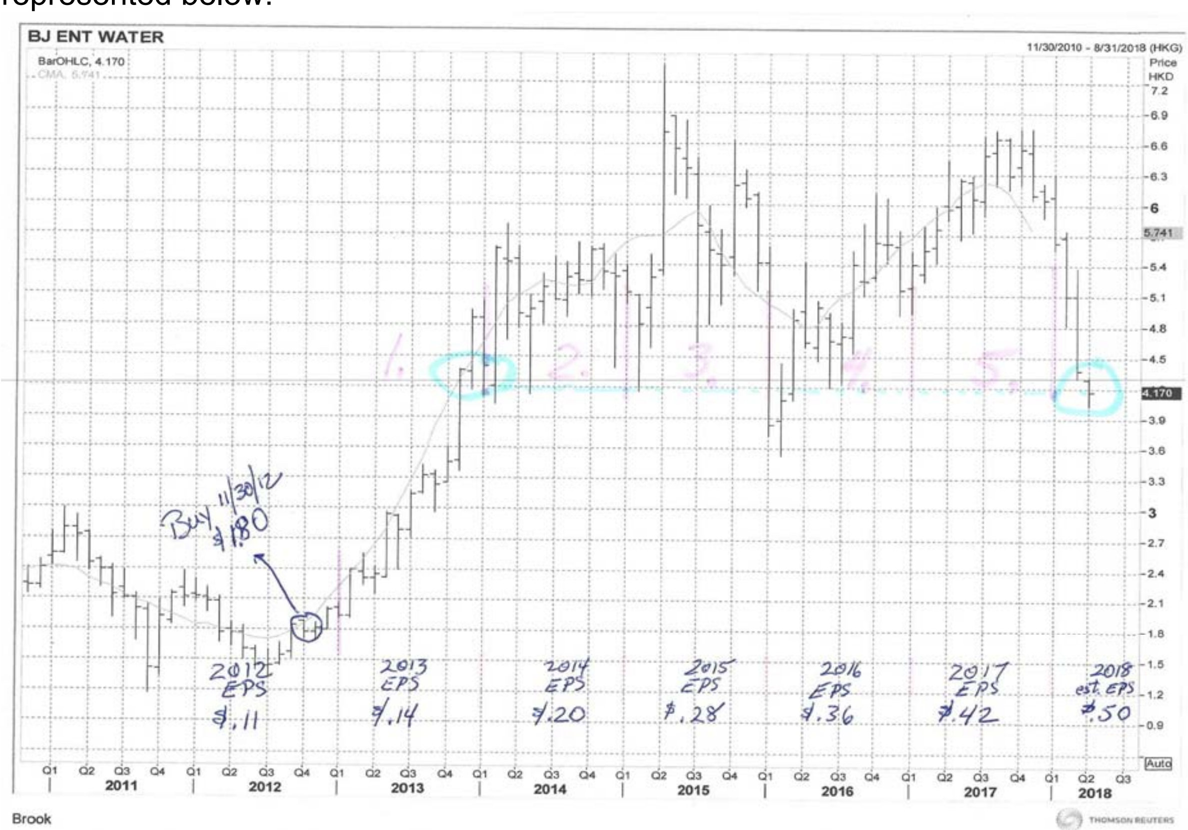
As we've noted in past commentaries, we are not invested in these areas with our portfolios. Our proprietary screening methodology seeks to identify fundamentally sound companies that are benefiting from operations in China. We invest with a business ownership approach, calculating a reasonable intrinsic valuation on all companies in our universe. We find values primarily in the overlooked, small/mid cap sectors, whereby our system determines a maximum price to pay.

This long term, value-oriented style has been under-performing in today's market environment which favors a relatively few, high growth names. In other words, we are cautious on relying on the forward expectations needed to support these current high valuations. It will become increasingly difficult to grow future earnings at the fast pace historically enjoyed by these few names.

Valuation gaps between high growth and stable growth companies that we own are extreme today.

In our portfolios, we have held a core holding for the past 5+ years in leading water treatment firm, Beijing Enterprise Water Group (code hk371, market cap HK$41.1 billion, US$5.3 billion). The PRC government considers water management a top priority in clean water-deprived China. The fundamentals of BEWG rate a high score on our in-house Banquet System (return on equity of 20%, net income and cashflow increasing the past 5 years, superior margins and a balance sheet not overly indebted).

We bought a full position in late 2012, at ~$1.80 (versus today's price of $4.17). Yet, even though the company's earnings have steadily increased since our purchase, the share price has been essentially flat the past 4 years, as represented below:



Rather unusual for a company's earnings-per-share to triple and see the share price remain unchanged! But, that's the current condition of the market in Hong

Kong…if not a technology or finance/real estate company, then there is no investor interest or following. For instance, internet/gaming favorite, Tencent (code hk700), has also seen earnings per share triple since 2014, but its share price has more than quadrupled! Tencent sells at 43.6 times trailing earnings, BEWG at 10.0 times, a significant divergence.

Our largest holding, leading smartphone casing manufacturer, Tongda Holdings (code 498hk, market cap HK$9.2 billion, US$1.2 billion), like Beijing Enterprise Water, has underperformed the overall market. Tongda's expertise in waterproof casing manufacturing will probably account for 25% of all Apple's waterproof/dust-proof iPhones this year. Impairment charges from two failed Chinese smartphone makers slowed first half earnings progress last year, but the outlook from large customer orders for this year (Xiaomi and Huawei, which are expanding overseas) is bright, especially with Chinese cellular operators fast forwarding 5G development. The share price valuation is undemanding at just 6.9 times expected 2018 earnings.

Another long term holding, leading wind power producer, Huaneng Renewables, reported last month that 2017 earnings per share increased 13.3%, as expected. In last year's July monthly letter, we noted the extreme value metrics of the stock, observing;

> *One example of the deep values favored by Ben Graham is our position in wind and solar power generator, Huaneng Renewables (code 958hk, 4.6% holding). HN Renewable sells at 8.8x last year's earnings and 6.7x this year's estimated earnings. Its historic P/E is 16.8 times. Return on equity today is greater than 30% and the shares are selling below book value. Sales, earnings and net book value have increased every year for the past 5 years. HN Renewables is the largest wind farm operator in China and has the highest net margins of all wind power companies. Its parent company is the State-Owned giant Huaneng Group (57% ownership), one of China's largest power producers. Various governmental policies strongly favor wind, solar and hydro power. Renewable energy is in the first priority of power dispatch in China as the government requires that grids purchase renewable power first.*

The depressed share price has bottomed, gaining 22% year-to-date, yet still sells at only 7.0 times this year's expected earnings. Quite cheap for a leading wind power producer.

Many small/mid cap stocks have seen gloomy returns in the low inflation environment since the 2007 financial crisis. Slow growth has stifled earnings progress and we note that more 400 listed companies in Hong Kong have reported negative earnings in the past year (taken from a list of 1,000+ stocks in Hong Kong on Reuters). For these mostly small/mid cap companies operating in China, it has been extremely difficult to advance business operations in a sluggish environment.

In a low growth era, investors have pursued the 'promise' of growth, such as with technology and biotech stocks, where the euphoric, self-manifesting buying today has exploded fundamental metrics. Value stocks, on the other hand, have been neglected.

Large cap growth stocks today are massively overvalued relative to many mispriced small/mid cap stocks. Stocks with stable earnings and clean balance sheets, such as those we own in our portfolios, are likely to rebound strongly when this market anomaly reverts.

Our weighted average expected price to earnings ratio stands at 6.8 times this year's earnings versus 11.6 times for the large cap, Hang Seng Index.

Sincerely,

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