September 14, 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:

	Aug 2018	Year-to-date
Hong Kong Partners LP*	-6.4%	-19.9%
Hang Seng Index **	-2.4%	-15.2%
Hang Seng Small Cap Index	-6.1%	-14.4%
MSCI HK Small Cap Index	-5.8%	-22.9%
HS Mid Cap Index	-4.5%	-21.2%

Partners' NAV $2.6331 after management fee and provisions, but before annual incentive fees of 15% on appreciation.

Weak sentiment prevailed in Hong Kong's stock market last month. The escalating trade war between China and the US, an absence of buying from mainland Chinese investors and economic woes in developing economies, such as Turkey and Indonesia, unnerved investors.

Our Hong Kong-listed, small/mid cap holdings are in proven businesses operating in China. We aren't betting on the next new phone app to be launched or any blockbuster drug or new online game to come to market. Rather, our companies are leaders in businesses that China needs most, such as clean water (Beijing Enterprise Water, code 0371hk), renewable energy (wind power HN Renewables, code 0958hk)), low cost urban housing (China State Construction, code 3311hk) and advanced smart meters (Wasion Holdings, code 3393hk).

Our holdings reported interim financial reports at or above expectations in August, still, share prices remained under pressure. Where earnings haven't met expectations, such as a few in the Information Technology sector (Tencent's interims were a miss, a stock we do not own), prices have declined more than the market (the Info Tech sector is down 24% year-to-date).

In 2015, China suddenly devalued its currency roughly 4 percent, sending markets reeling. The resulting capital outflows meant the PRC ended up rifling through $1 trillion of its foreign currency reserves in order to support the yuan. Probably not an idea being considered by Chinese authorities today.

China's deleveraging program of the past year has slowed growth. The main aim of the program was controlling the unregulated, "Shadow Banking" loan market. Renminbi bank loans (mainly to State-Owned Enterprises), by far the largest part of total financing, are up a healthy 11% in the first seven months, but the area of main concern to analysts (entrusted loans, trust loans and undiscounted bankers' acceptances) has slowed dramatically.

Though China has slowed growth as it sought to reduce its debt build-up, it is important to note that sovereign China has borrowed very little overseas (unlike some of its real estate and private companies) and is not susceptible to foreign capital flight movements which devastated many Asian countries in the 1997 Asian Financial crisis.

The deleveraging campaign is affecting the loan-starved, private sectors of the economy. Consequently, expectations today in the Hong Kong stock market are not high and stocks have become oversold. Further, when share prices decline, as is typical, analysts begin reducing their projections, adding to the jaded outlook.

Last month, though, China's top economic advisor, Liu He, hinted that China may be preparing a major policy shift in regards to the slowdown in the private sector. Should an easing policy be announced, reaction in the depressed China/Hong Kong markets would be like a lightning strike in a dry forest.

The Hang Seng Index sells at 10.1 times trailing earnings. Our weighted average price-to-earnings ratio is just 5.8 times 2018 estimates. We have 20% sidelined cash available for future investment (as Warren Buffett has said, "Cash combined with courage in a crisis is priceless").

Many years ago, when South Ocean started its investment program in the early 1990s, we were privileged to have gained access to many of Hong Kong's leading thinkers. One of our earlier friendships was with Bill Overholt, who worked as an advisor to Banker's Trust.

Bill recently penned an insightful view on China, relevant to today's dialogues about the Middle Kingdom, which is shared below.

Sincerely,

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The West is getting China wrong

11 August 2018

Author: William H Overholt, Harvard University

The dominant narrative in the West reads that China has a stable administration run by a 'president for life' who is the most powerful leader since Mao Zedong. China has escaped the pressures for political change that transformed earlier Asian miracle economies at similar levels of development. It has consolidated a particularly repressive market Leninism, which is destined to grow rapidly for the indefinite future. And its increasingly centralised economic control and ambitious industrial

policies are so efficient that they constitute an unlimited threat to the West.

These arguments are wrong. China has not escaped the pressures of political complexity that forced political reform elsewhere. Rather, those pressures are so powerful that the whole structure of Xi Jinping's administration is a reaction to those pressures.

Around 2005 China's leadership became fearful that the country was pulling apart. Economic reform lagged. Powerful interest groups were taking control of policy. Local governments were disobedient. Ministries defied the premier. Corrupt generals weakened the military. Corruption was undermining Party legitimacy. These forces are powerful: China's obstreperous provinces and interest groups are often larger than European countries.

Apprehensive about emergent crisis, China's leaders designed a new economic plan based on market allocation of resources combined with a desperate centralisation of government. To facilitate decision making, the top leadership would have seven leaders rather than nine and would exclude "extreme" opinions (pseudo-Maoist Bo Xilai and reformist Li Yuanchao). Key policy areas would be controlled by small leading groups, including a new National Security Council, all chaired by a single leader. Unlike his predecessor, the new leader would command the military immediately. These decisions were made by workable consensus separate from the selection of Xi Jinping. Contrary to the Washington meme, Xi is not a Putin. Xi is a creature of the Party. Putin's party is a creature of Putin.

Xi was allocated power along with a difficult reform assignment. Market allocation of resources would damage the power and finances of every major power group: state enterprises, banks, the Party, the government, the military and local governments. Xi's instrument for dislodging reform opponents — the anti-corruption campaign — not only alienates the leaders of all those sectors but also leaves officials frightened to implement reforms.

So determined was the opposition, that supporters hoped — best case — that Xi would spend his first term consolidating power and his second implementing reforms.

Certainly Xi's first term was spent consolidating his position. Ferocious opposition (summarised by a leading executive as 'you die or I die') stimulated fears of personal retribution and reform reversal after Xi's second term, hence the decision to allow Xi a third term if necessary.

The Western conclusion that this makes Xi 'president for life' and the most powerful Chinese leader since Mao is diametrically wrong. Xi does not have the power to unilaterally implement his agenda or to remain in power indefinitely. His repression of opponents does not prove his invincibility; it reflects his vulnerability. His many titles reflect insecurity. Deng Xiaoping, confident of power, governed China as honorary chairman of the Bridge Players' Society.

Xi's dilemma is reflected in his inability or unwillingness to make strategic decisions. He advocates rule of law but strengthens the Party commission that decides verdicts. He advocates marketisation of state enterprises but strengthens Party committees' control of business decisions in both state and private enterprises. Faced with a choice between rapid reform with much slower growth, or rapid growth with much slower reform, he promises both rapid growth and rapid reform. This is more Theresa May than Mao Zedong.

The Asian miracle economies all began as repressive, authoritarian polities and extremely centralised economies. Success made these economies and polities so complex that overcentralised rule became unsustainable. In Taiwan, Jiang Jingguo, who was president in 1978–88, recognised the necessity for change, overcame his ruthless Leninist history and engineered a gradual economic and political transition. In South Korea, Park Chung-hee tried to push back the tide during his presidency, so the country's

transition began with his assassination in 1979 by a close colleague who understood the need for change.

China's current leadership has acknowledged the new economic environment more explicitly and has planned more brilliantly than any predecessor, but politics is inhibiting economic reform. Xi is trying to marry Jiang Jingguo's economics to Park Chung-hee's politics. But trying to subdue the political tide creates a cycle of destructive repression.

Xi is vulnerable. He disappears from the media for days. An adulatory movie is suddenly curtailed. Portraits are suddenly removed. His bodyguards are suddenly changed. Lawyers and students are increasingly assertive. The annual Beidahe leadership meeting is contentious.

This is the opposite of an omnipotent president for life running an economy inexorably destined for rapid growth. US policies based on that false premise lead Washington to declare defeat for its policy of engagement, declare China a fearsome national security enemy and launch desperate economic warfare against the presumed superior economic prospects of China's politicised economy. Sad.

Washington would benefit from more confidence in the free enterprise system and more perspective on China's political dilemma. Trump's fear of the Made in China 2025 policy reprises needless US fears of being swamped by Japan's fearsome industrial policy in the 1970s–80s.

Likewise, the US policy of engagement has not failed. It has created the anticipated social and political pluralism. China can continue its cycle of self-destructive repression at the possible cost of interrupting its rise, it can democratise, or it can find a new way to channel the tide of pluralism. Critics of the engagement policy understand neither the time required for change in China's vast society nor the reality beneath Xi's adulatory headlines.

William Overholt, Senior Research Fellow at Harvard University, is author of The Rise of China *(1993), the first book to predict China would become a superpower, and* China's Crisis of Success *(2018), from which this article derives.*

*Hong Kong Partners LP risk disclaimer:

- Hong Kong Partners LP (The "Fund") primarily invests in the Hong Kong equity market with a Greater China focus.
- The Fund invests in China-related companies which involve certain risks not typically associated with investment in more developed markets, such as greater political, tax, economic, foreign exchange, liquidity and regulatory risks.
- The Fund is also subject to concentration risk due to its concentration in Hong Kong, particularly China-related companies. The value of the Fund can be extremely volatile and could go down substantially within a short period of time. It is possible that a substantial value of your investment could be lost.
- You should not make investment decision on the basis of this material alone. Please read the explanatory private placement memorandum for details and risk factors.

**Index Descriptions: The Hang Seng Indexes are a widely recognized capitalization-weighted indexes that measures the performance of the three largest-capitalization sectors of the Hong Kong stock market in descending order. The Hang Seng Index measures the largest 52 market capitalized listed companies in Hong Kong's stock market. The Hang Seng Mid Cap Index represents the next 193 largest capitalized listed companies, the Hang Seng Small Cap Index represents the next 187 largest capitalized listed companies in Hong Kong.

The MSCI HK Small Cap Index is a free float-adjusted market cap weighted index designed to measure the performance of small cap equity securities in the bottom 15% of equity market capitalization in Hong Kong. With 69 constituents, the index represents approximately 14% of the free float-adjusted market capitalization of the Hong Kong equity universe.

The Hong Kong Partners LP (HKP) is benchmark agnostic and its corresponding portfolio may have significant noncorrelation to any index. The portfolios may invest in all sectors (within and/or on other stock markets) and the composition of securities in the portfolio may change periodically depending on market conditions at the time. Securities in the portfolio will not match those in any index.

Index returns are generally provided as an overall market indicator. You cannot invest directly in an index. Although reinvestment of dividend and interest payments is assumed, no expenses are netted against an index's returns. Index performance information was furnished by sources deemed reliable and is believed to be accurate, however, no warranty or representation is made as to the accuracy thereof and the information is subject to correction.

Before investing you should carefully consider the Partnership's investment objectives, risks, charges and expenses. This and other information are in the prospectus, a copy for Accredited Investors may be obtained by inquiring to info@south-ocean.com. Please read the prospectus carefully before you invest.

The principal risks of investing in HKP: Equity Securities Risk. The value of the equity securities the Fund holds may fall due to general market and economic conditions. Foreign Securities Risk. Investments in the securities of foreign issuers involve risks beyond those associated with investments in U.S. securities. Industrials Sector Risk. Companies in the industrials sector may be adversely affected by changes in government regulation, world events, economic conditions, environmental damages, product liability claims and exchange rates. Consumer Discretionary Risk. Companies in this sector may be adversely impacted by changes in domestic/international economies, exchange/interest rates, social trends and consumer preferences. Information Technology Sector Risk. Information technology companies face intense competition, both domestically and internationally, which may have an adverse effect on profit margins. Detailed information regarding the specific risks of Hong Kong Partners LP can be found in the prospectus. Additional risks of investing in HKP include equity, market, management and non-diversification risks, as well as fluctuations in market value and NAV. An investment in a private limited partnership is subject to risks and you can lose money on your investment in the limited partnership.

There can be no assurance that HKP will achieve its investment objective. The LP's portfolio is more volatile than broad market averages. Shares of HKP cannot be bought or sold publicly, there is no active market in the Units and there are restrictions imposed on Limited Partnership unit transfers. Partnership redemptions are handled by Authorized Administrators of the Partnership.