SOUTH OCEAN 南海管理有限公司
MANAGEMENT, LTD.
HONG KONG

April 13, 2012

Dear Clients, Partners, and Friends,

The results for South Ocean Managementôs Delaware LP, Kong Partnersô L.P., before incentive fees, were as follows:

	Mar 2012	Year-to-Date
Hong Kong Partners LP (net)	- 0.2%	11.1%
Hang Seng Index	- 5.2%	11.5%
MSCI HK Small Cap Index	- 3.9%	14.1%

Partnersô NAV for March $2.6156 after management fee, but before annual incentive fees of 15% on appreciation.

Our portfolios of cash-rich, Hong Kong-listed, small/mid cap holdings of china-related companies continued to recover last month. The Hang Seng Index has increased this year on The People's Bank of China expected cut of the reserve requirement ratio - the amount of funds banks are required to set aside. This expected interest rate cut continues to support market sentiment.

Yet, the market recovery has been erratic, as China enters a new phase in its economic development. We touch on all this in the following.

Sincerely,

Brook McConnell
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Hong Kong

"…Nobody knows nothin' about China."
Barton Biggs, former Chief Investment Officer of Morgan Stanley Asset Management

Ever since last summerôs economic crisis in Europe and the debacle of the USAôs loss of its tripe A rating, the markets have been dysfunctional (senior CNBC journalist, Herb Greenberg, elaborated last October, Yes, Virginia, the Markets are Broken).

The market is still convalescing today, as evident in the trading volatility of stocks.

For example, last quarter, we purchased shares in VST Holdings soon after visiting with the companyôs CFO.

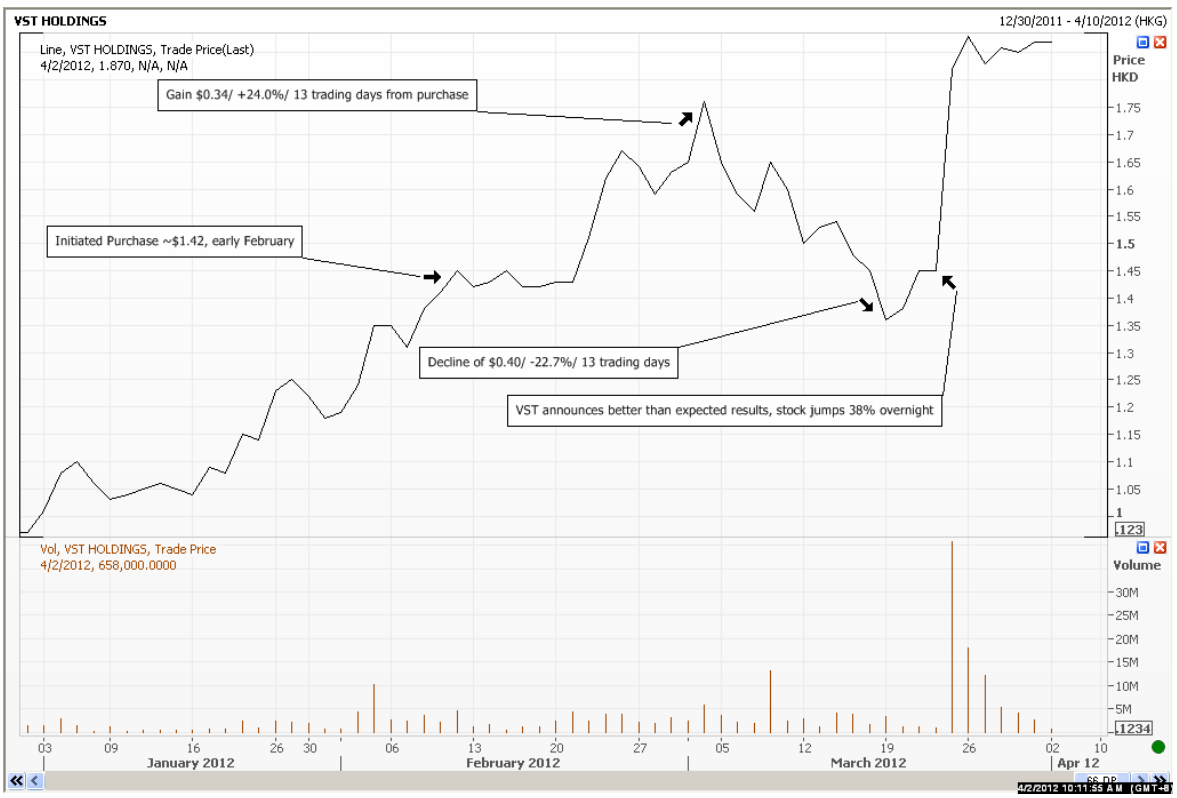
The share price at that time seemed to have reached a bottom, amid the turbulent global economy and after the disastrous Bangkok floods in November (which affected the entire electronic supply chain worldwide). At our purchase price of ~HK$1.42/share, we paid, for one of Asiaôs largest consumer electronics distributors, 3.8 times for trailing earnings (see my [February write-up]() on VST Holdings).

The shares continued to recover and, within two weeks, the stock increased a further HK$0.34 per share or +24% over our purchase price.

Shortly thereafter, though, in early March, concerns over a possible Greek default, high oil prices and the speed of an economic slowdown in China sank investor sentiment. For no specific reason we could find, VSTôs stock price abruptly declined to below where we had just been purchasing it.

At that moment, I was undecided about adding to our new 3% position, and sat on my hands. While I dithered, the company announced its financial results, reporting 2011 net profits up 24%, beating consensus. The share price shot up 38% on the news, to new highs (see following chart).

In all, the share price gyrated a total of 85% in a short period. All this unsettling volatility is indicative of a very nervous equity market, one that is not yet stabilized. Market participants are definitely few and they are uncertain of their holdings.



We point out this skittish market environment as the reason we are holding a bit more than normal cash on the sidelines (20% of total portfolio value). If after this rally, which began last October, the market should consolidate in the ensuing months, we would be in a position to take advantage of any opportunities with this cash.

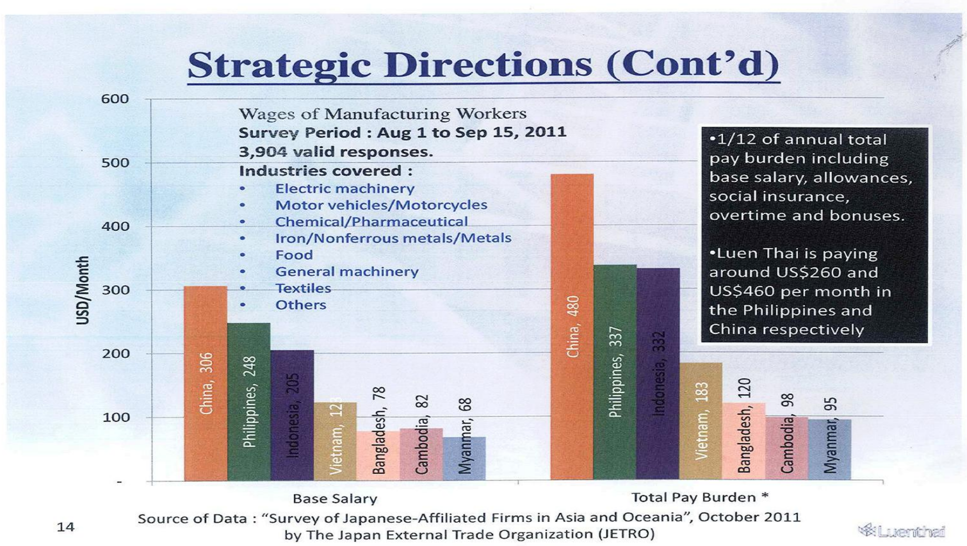
Much has been written of late about rising costs in China. Willie Fung Wai-yiu, chairman of Top Form International - a leading international lingerie manufacturer - explained

> *"You see, in Shenzhen, a migrant worker costs more than 3,000 yuan (HK$3,680, US$475) a month, twice what they cost two or three years ago. But the price of a bra, a skirt and*

other clothing that is to be exported overseas has remained almost the same in the past 20 years," said Fung, who is also chairman of the Hong Kong Garment Manufacturers Association. "I think we will only see more factories close in Shenzhen and move."
Top Form has already moved more of its manufacturing to Thailand and Cambodia due to lower costs - a move that has proved fruitful, as evidenced by the group's bottom line. Its factory in Thailand, which employs about 6,000 workers, accounted for half of the group's production output by March last year.
Manufacturers say the poor figures are no surprise.
A source close to Taiwanese manufacturer Foxconn said that large, labour-intensive manufacturers had been pulling out of Shenzhen amid falling profits.
According to mainland media, Foxconn employed 450,000 workers at its Shenzhen factories in early 2010, and its operations there contributed more than US$48 billion to the city's exports that year.
"Now Foxconn keeps about 350,000 workers in Shenzhen. We will keep moving workers and orders to our new plants in hinterland provinces. Our labour force at the Shenzhen factories will drop to 200,000 workers in the next three or five years," the source said.
…"But the fact is that traditional labour-intensive manufacturers now account for more than 70 per cent of Shenzhen's exports, and many of them still rely on overseas orders while lacking the will and ability to upgrade their technologies and adapt," Zeng said. "This year will be an extremely tough one."

Companies must cope with this phenomenon. As Fung explained above, as rents, wages and raw materials costs have skyrocketed in Shenzhen (the Special Economic Zone bordering Hong Kong to the north), manufacturers' profits have dwindled.

One Hong Kong Chinese owned/managed company we recently started buying, a quality garment manufacturer which makes menôs polo shirts and sweaters (for a US brand started by a designer of Brookôs Brother neckties) and luxury leather handbags, has moved its new production offshore, to the Philippines. Wage costs are lower there and the government provides incentives. Management shared this chart with us on wage costs in Asia:



This companyôs decision to increase production overseas is directly attributable to rising wage costs on the mainland. (We first visited its Guangdong Province factories in 2005 and recently started buying the shares. Its 2011 core EPS (adjusted for one-offs and discontinued business) was

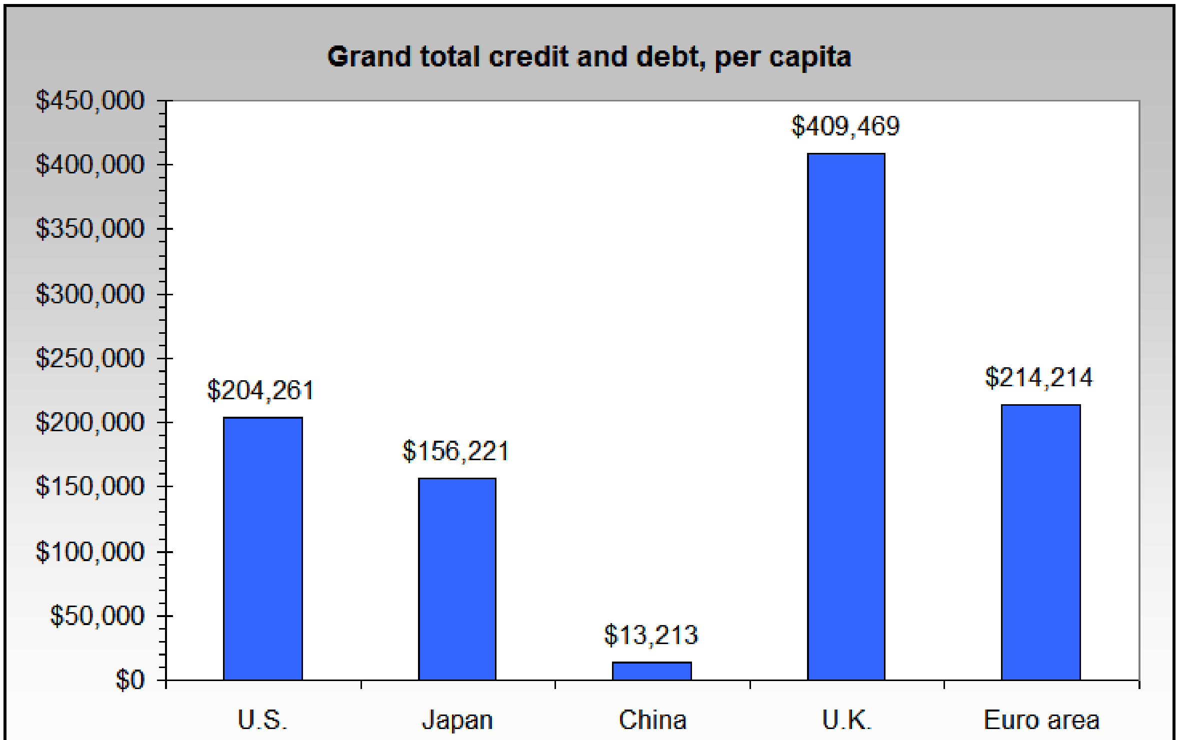
HK$ $0.20 and DPS HK$0.08. Tangible NAV/share is HK$1.92 versus a recent share price of $1.01. Valuation is quite cheap, 5x P/E, 8% yield and 0.5x P/B, implying zero earnings growth. Yet, after visiting management, this company will probably witness dramatic EPS growth of at least 20-30% over the next 3 years. Significantly, this manufacturer's high quality customers are increasing their business with the company as it moves offshore. Last, excess cash of US$100mn, or HK$0.78/share, makes this investment an almost debt-free bet).

We are, as a result of this rapid transformation, less focused on investing in China as a "low cost producer". Rather, we see it as a country about to enter a new development phase, similar to the USA in the early 1950s: a rising middle class.

BNP PARIBAS discussed this in a paper, 2015-2020: A nation of middle-class people under social security coverage:

> *We define middle class as households with median or higher household income (above USD10,000 p.a.) who can afford housing, consumer durables such as auto and PC and can also spend increasingly on medical-education, tourism, telecom, media, internet, financial services.*
>
> *The absolute number belonging to the middle class or above expanded steadily over the past 20 years. Based on NBS's (National Bureau of Statistics) urban household income survey 2008, we estimate a 40% increase in urban household or 240m people in the middle class category or above, which translates to 90m households. In rural areas, about 5% of the population, or 35m people or 10m households, reached a similar income level. Due to its size, income, wealth accumulation and growth trend, the emerging middle class is the focus and trend setter of China's private consumption. China's total resident-owned assets was RMB70t, of which physical assets - which comprised mainly housing-rural land – was 57% (around RMB40t) and liquid financial assets were about 43%. Based on our projected 8.8% GDP growth during 2010-2015 and 7.5% during 2016-2020, per capita urban income will double by 2020 to about USD20,000; 400m or 50% of the urban population or roughly 150m urban households should reach the middle class threshold. In the rural area, roughly 120m or 40m households or the top 20% will have similar income. In all, there will be 520m people or 190m households in the middle class category. This additional 90m households will boost middle class by 17 ppt to 37% of total population, this is similar to the that of US in the 1950s and Japan in the 1970s; similarly, we expect a robust consumption boom to follow with an emerging middle class population. Though the USD10,000 household income looks very low by global standards, but by Chinese standards, a nation of middle class will usher in a new era in China's economic development. With a more affluent population, consumption and domestic demand is expected to take over from investment and export as growth engines of China's USD10 trillion economy in 2015.*

Importantly, China is not dependent upon paying down debt, as much of the rest of the world is today;



As of Apr 2012. Excludes accruals like Social Security & Medicare, and regional or state debt. Source: Respective central banks, some data estimated, especially after 2008. http://www.nowandfutures.com

We believe the impact of these trends isnõt well appreciated by investors and we shall be writing more about this transformation and what impact we see happening as a result over the months and years from now.

Lastly, our holding in share-suspended, Chaoda Modern Agriculture, postponed its interim results announcement for the six months ended 31 December 2011 pending publication of its delayed June 30th annual results. The Company said, ñé it will endeavor to publish the Interim Results as soon as practicable.ò

We contacted the Market Misconduct Tribunal and learned that, after the last substantial hearing on March 2, the chief justice and another member had retired to write up their verdict. Their hand down may take up to two months to prepare, we were informed. The Hong Kong stock exchange may need to óanalyzeô this verdict before releasing the suspension on the shares.

Overall, our holdings are quite cheap (less than 3 times weighted average estimated earnings per share this year), with the blue chip, Hang Seng Index selling today at just 8.9 times trailing earnings (versus an historic average of 14 times).

Brook McConnell
Hong Kong