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

July 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:

	Jun 2012	Year-to-Date
Hong Kong Partners LP (net)	-1.6%	1.2%
Hang Seng Index	4.4%	5.5%
MSCI HK Small Cap Index	-2.7%	0.6%

Partnersô NAV for Jun $2.3248 after management fee, but before annual incentive fees of 15% on appreciation.

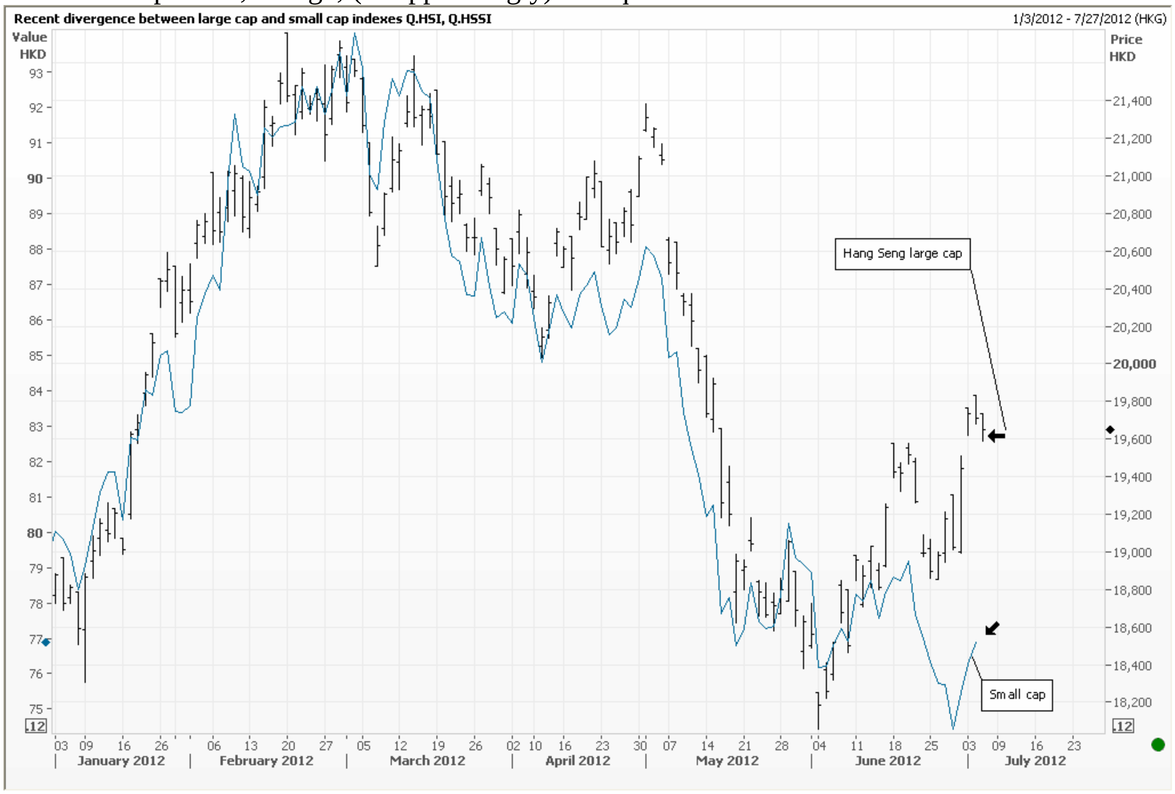
The first six months have been volatile and unsettling in Hong Kongôs stock market.

Jim OôNeill, Chairman, Goldman Sachs Asset Management, who coined the emerging market phrase óBRICô (Brazil, Russia, India, China), recently wrote;

> *So, here's the situation. The mood is grim. A lot of economic data has turned grimmer, which makes many people so bearish about many things, markets included. Much of the "mood" centres on a sense of hopelessness about Europe, with the risk on/risk off mentality seemingly suggesting that it is impossible to differentiate markets as an investor, and so on.*

Itôs quite frustrating to lag the overall marketôs performance, as what the small/mid-sized capitalized stocks, in general, been doing this year. In the last two hours of trading, for instance, on the last day of June, large caps jumped on news of the EU summit agreement.

The small cap index, though, (disappointingly) was quiet.



The gainful Greek elections, the EU summit agreement, and various easing measures in emerging markets drove Hong Kong large cap stocks upwards in June after the previous monthôs tumultuous falloff. Last monthôs appreciation was based primarily on speculation that Chinese and European central bankers will ease monetary policy, or render another rescue plan.

Anticipated rescue plans or Quantitative Easing policiesô initiated by uncertain central bankers arenôt events by which we decide to put capital to work. And, even though an acquaintance of mine flatly stated he was giving up on small cap investments in Hong Kong, ñé can't make money anymore,ò and one of our small cap research analysts at an EU-based brokerage was let go last month, we take a longer term view of events and moods in the markets.

We look to invest in shares of businesses, listed in Hong Kong, benefiting from growth in China, with low price to growth (PEG) ratios and strong balance sheets. We keep in close contact with managers of our holdings.

Heavily researched large cap shares in Hong Kong are generally fully priced. We concentrate in areas of the Hong Kong market that are not in the limelight, delving down into the smaller, non-index-related, less researched stocks where mispricing is more often found (see notes below).

Over periods of uncertainty and market cycles, our 18 month to 3 year outlook and holding period tends to beat the averages. But, the small/mid cap segment has been lagging the larger cap shares lately. Risk appetite for smaller, fast growth companies has been dampened by the weak euro, political uncertainty in Greece, Spain and France and the slower-than-expected monetary easing on the mainland.

Take, for instance, the small capitalized, second board index in Hong Kong, the Growth Enterprise Market (GEM), as an example.

This is a snap shot of the GEM through May 2012

	May 2012	May 2011	Year on year change (%)
No. of listed companies	176	168	
No. of listed securities	178	170	
No. of newly listed companies	2	2	
Turnover value (HK$mil) **- Daily average**	2,541 116	8,060 403	-68.47
Turnover volume (mil shares) **- Daily average**	12,243 557	26,188 1,309	-53.25
No. of deals **- Daily average**	85,399 3,882	196,414 9,821	-56.52
Total issued capital (HK$mil)	9,348	10,322	-9.44
Market capitalisation (HK$mil)	78,301	133,788	-41.47
Average P/E ratio (times)	17.96	24.42	
Average yield (%)	0.56	0.97	

It has been not rewarding for investors in GEM stocks;

YEAR	MSCI HK Small Cap Index	HKP	HS-I	GEM
Dec-01	-3.7%	-7.7%	-24.5%	-43.3%
Dec-02	-13.4%	-19.7%	-18.2%	-48.3%
Dec-03	60.7%	78.4%	34.9%	24.8%
Dec-04	25.7%	8.7%	13.2%	-16.6%
Dec-05	1.0%	7.7%	4.5%	1.9%
Dec-06	21.7%	28.0%	34.2%	21.6%
Dec-07	29.0%	15.3%	39.3%	10.2%
Dec-08	-66.7%	-47.6%	-48.3%	-71.4%
Dec-09	103.0%	83.7%	49.4%	75.6%
Dec-10	35.2%	22.3%	7.1%	19.7%
Dec-11	-28.6%	-32.7%	-19.8%	-41.4%
Std Dev	0.45	0.41	0.31	0.43

(HKP is our Hong Kong Partners LP, HS-I is the large cap Hang Seng Index. Our small/mid cap portfolio has consistently out-performed the GEM bourse, and, with less risk. The GEM index is down another 20% so far this year in Hong Kong. We donŏt focus much in property/finance-related stocks, which has been an outperforming sector for the MSCI Small Cap index. Hong Kong has the highest priced real estate on earth today and is not an area of interest to us).

Since 2000, the first year of the MSCI HK Small Cap Index, the small caps have outperformed the large cap Hang Seng Index in 8 out of 11 years. We donŏt try and hedge our bets in the market. And, timing when the group outperforms is anyoneŏs guess. As David Weidner, senior journalist with MarketWatch recently commented (So long, suckers ð Iôm leaving Wall Street: Some lessons from 15 years observing the industry):

You can't time the market: Also, technical analysis is phooey. Momentum plays are foolish. Anyone who wants to sell you a plan to beat the market is full of baloney. Investing schemes are exactly that. As I've written before, some people will tell you that you can hedge your bets. But insuring trades has never made sense to me. If you have to spend money to hedge a bet, it probably means you can't afford to invest the money.

Further, a recent Goldman Sachs report on ETF Hedging concluded:

> *Proceed with caution:*
>
> *The rise of investor usage of ETFs as hedges continues. In a bid to gain quick exposure to evolving markets, avoid single stock M&A risk or take sector views, we believe the use of "blunt force" hedging via ETFs may **impair** portfolio returns and potentially create negative alpha.*
>
> *…In both cases investors are arguably better off reducing long exposure or selecting individual stocks on the short side.*

We have been alluding to this for years in our monthly letters, why we donôt short in the Hong Kong market. That long held conviction of ours is now becoming a trend in Asia, as reported by Reuters; *Asian hedge funds ditch short-selling for long-only game*.

The following are some notes on a few of our portfolio holdings;

Fujikon was a holding we mentioned in our January letter, symbolizing the cheapness of our holdings.
Our portfolios are concentrated in holdings of primarily small/mid capitalized, cash-rich stocks. The trailing, estimated price earnings ratio (weighted average) is approximately 4 times today.

That is very much undervalued!

For instance, one of our long term holdings, leading audio headset manufacturer, Fujikon, sells at ~HK$1.00/share in the market today, about one half its net equity/book value. – As of Sept 2011, Fujikon has a net cash position of HK$379.6 million, versus a current market cap of HK$404 million. Cash is just slightly less than the total market cap of the shares! We get the business, then, essentially for free. Ex-cash (there's no long term debt), the price earnings ratio is effectively zero, with an 8% dividend yield.

In April, management gave us an update regarding the companyôs restructuring efforts along its headphones/audio product lines. Last month, in June, the company reported its financial progress.

The highlights:
- Revenue: HK$1,305.9 million, up 6.7% (2011: HK$1,223.6 million)
- Gross profit: HK$230.1 million, up 25.2% (2011: HK$183.8 million)
- Profit attributable to equity holders of the Company: HK$56.4 million, up 88.1% (2011: HK$30.0 million)
- Basic earnings per share: HK13.8 cents (2011: HK7.3 cents) up 89%!
- Final and special final dividends (per share): HK15.0 cents (2011: HK5.0 cents).

The shares now sell 50% higher than in January, trading at over HK$1.50/share.

Another holding is Mainland metal recycling company, China Metal Recycling (773). The stock sold off heavily on worries the steel industry in China is slowing. Yet the scrap share of total steel production is growing very fast, and this company is expanding rapidly by buying up weak competitors. It sells at 4x current and 3.5x next yearôs earnings, 1.1x book value, 30% ROE, yield 5.2%, and the Chairman started repurchasing shares again this month. We donôt believe there is anything negative happening with the companyôs operations to justify this low a valuation.

We wrote about Apple iPhone/iPad distributor VST in our January letter.

One broker noted in their recent *BUY call;*
VST is China's 3rd largest IT distributor by revenue (FY11) and distributes IT products for global brands such as HP, Dell, Seagate, Lenovo, and Apple.

- *VST's cash cycle remains strong with healthy and declining AR and inventory days. The Group's balance sheet has also improved substantially with its end-FY11 net debt/equity at 11% down from 30% at end-FY10.*

- *While global PC demand has slowed, we believe VST will benefit from its exposure to stronger growth regions such as China & SE Asia where shipments were up 7.9% & 17.2% y-o-y respectively in FY11 vs. global: 1.8%.*

- *We like VST for its: i) Exposure to high PC growth regions, ii) attractive FY12F yield of 6.1% and iii) Undemanding valuation of 3.3x vs. peers of 9.1x. Our TP of HK$2.34 is based on 5.0x FY12F PER.*

We are usually early in our investments and it is gratifying to see when the market also begins sharing our views.

My partner, Percy Au-Young, wrote this note about one of our favorite stocks today, cash-rich, Polo and Coach products manufacturer, Luen Thai (code 311);
It was listed in mid-2004 at $2.97 and did a top up placement at $4.07 in early 2005. Though profit had eased off from pre-listing peak, it still reported positive earnings every year since listing. Meanwhile book value per share has been built up to $2.41/share, of which $1.92 is tangible with net cash about $0.60/share. Last year's core earnings per share were $0.20 and a dividend per share of $0.08, and we see this and next year's profits strong.

The shares are trading at only HK$0.90/share or just 4.5x trailing earnings and a 9% dividend yield, even if unluckily they see a 50% profit decline, valuations are still respectable at 9x and 4.5%. Also, even if they lost $0.20/share for two consecutive years, it will have just given up some of the idle surplus cash. On the other hand, company did 2 minor acquisitions (one connected) recently and those idle funds now have immediately be turned into 20%+ return generating assets (both acquisitions were done at below 5x P/E) and thus should enhance the bottom-line automatically.

While 2011 bottom line was distorted by a few exceptional items, the company pointed out that net profit of continuing business was about US$25.2mn. The accessories division is the growth driver this year as they started to produce luxury bags for Coach in late 2010. Last year there was still a loss in H1 but it turned into a profit for the full year. They produced 3.4mn bags last year and this year, it will probably amount to 5.4mn, and maybe 6-7mn next year. They attracted the Coach business with their new manufacturing facilities in the Philippines, along with lower wages and lower import duties for raw materials.

A weak spot could be the Europe garment business esp. with Esprit as one of its key customers. But I guess growth from Coach bags could more than offset any weakness there.

In April they bought-out a partner's stake in a 50:50 jv with Yue Yuen, which makes garments for Adidas, for US$4.6mn. As requested by the buyer, it was settled with a CB with conversion price at $1.20. Yue Yuenhas been a shareholder in Luen Thai since IPO, and its holding will rise from 8.95% to 11.59% if the CB is converted. The buyout allows Luen Thai to smooth out some operational issues which had caused the JV to record a very small loss in 2011 vs a profit of US$2.5mn in 2010. New order plans with Adidas have been set, and it is believed next year this operation will see results back to 2010 levels.

Last May, Luen Thai announced plans to pay RMB88mn for a shoe manufacturing and marketing business from major shareholder, still pending minority approval. Net profit was RMB21.3mn in 2011, so valuation is just over 4x P/E. Customers are mainly international brands. It has been explained that the acquisition was intended to allow this company to grow bigger by tapping the listco's resources, including production facilities in the Philippines which appeal to certain customers who like to (and are demanding) manufacturers to diversify production out of China. It is also believed 2013 contribution from this business should at least match its 2011 profit, thus adding another 10% to the bottom line from 2011 levels.

Another holding is LCD manufacturer, Truly International code 732, which is the largest small-to-mid size LCD module provider in China. It claims domestic handset market share of 50-60%. We met with the management recently (whoǿve weǿve known for almost 15 years) to hear how the company is now aiming towards the automotive display market to combat declining ASPs in its traditional handset modules business lines.

Truly produced HK$10.5 billion (US$1.35 billion) in revenues last year and is growing its top line at over 20% a year.

The transition to higher margin smartphone LCD applications should support continued revenue growth in the future, while the higher margins from its automotive displays (>20% gross margins vs. 12% from handset LCD modules) should see overall improved margins going forward. Management targets revenue growth this year of 20% to HK$12-12.5 billion. The stock trades at just 6x this yearǿs expected earnings which is below its mean PE of 8x and a discount to its global peers, 0.7x book value, HK$1.1billion cash and long term debt less than 7% of total capital.

Please ask Joyce for a table on all holdings.

Fears of slowing growth and skepticism from corporate governance issues and delayed earnings releases have knocked down many stocks in Hong Kong this year, including some large cap stocks like Sun Hung Kai Properties and Chinese Estates. Many of these stocks are illiquid and can prove difficult to buy in this slow market. We leave orders in with our brokers, slowly picking away with our 32% cash position, as opportunities arise.

A screen we performed on 450 listed China stocks in Hong Kong shows how low valuations in the China-ralted sector have become todayé

ROE Comm Eqty, %, 5 Yr Avg	ROC Tot LT Cap, %, 5 Yr Avg	Gross Profit Margin, %, 5 Yr Avg	Price to Cashflow	Cash Flow/Shr (dil.), TTM
12.3	10.7	27.9	9.5	0.6

LT Debt/Tot Eqty, %, FI	Price to Book	Close Price	Bk Val/Shr, Tot Eqty, FY	Basic Normalized EPS, FY-5
33.2	1.8	4.72	3.1	0.20

EPS LFY	PE LFY	EPS Primary Consensus, FY1	PE FY1	EPS Primary Consensus, FY2
0.39	15.6	0.57	9.0	0.68

PE FY2	EPS Primary Consensus, FY3	PE FY3	Dividend Per Share	Dividend Yield
8.0	0.81	6.9	0.11	2.7

There are many treasures in this sunken sea chest and China shares will be very rewarding to patient holders one day.

Remember, chinaôs potential buying power is its vast middle class. About 247 million Chinese, 18.2% of the population, qualify as middle class, meaning their households spend between $10 and $100 a day on average, according to Brookings Institution economist Homi Kharas. If current patterns continue, the number will soar to 607 million by 2020, and spending by China's middle class will rival that of the U.S., after adjusting for inflation and purchasing power.

Consumption will be a major driver for Chinaôs growth.

And, unemployment in China is only 4.3%. (The US unemployment rate, in contrast, has been stuck at over 8% for past 44 months because, with the loss of $9 trillion in housing/real estate values since 2006, the small entrepreneur today doesnôt have the collateral value to go to the bank to take out a business loan these days and provide employment).

With the sometimes extreme levels of negative/pessimistic outlooks and views in the media towards China these days, itôs uplifting to come across this book review in our local Sunday Post Magazine, written by an African economist. We have based much of our investment commentary along these views. Hope you enjoyé

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Winner Take All, Economist Dambisa Moyo has raised ire and eyebrows with her claim that there is only one country on the planet with a firm grip on the realities surrounding global resources

Winner Take All is presented as a warning to the West - it's subtitled *China's Race For Resources, and What it Means For Us* - but the book reads more like a hymn of praise to China. When asked if she regards its story as scary or thrilling, she doesn't hesitate.

"Oh, I think it's fantastic. I think it's fundamentally fantastic - and also in the literal sense of the word. You know, it's fantastic - it's a good thing - but also 'fantastic' as in something really tremendous. They bought a mountain in Peru - half the height of Mount Everest - they bought the mineral rights. I flew in from Canada this morning, where they've done a laptops-for-pork deal. They're importing beef from Brazil and in return they'll build roads and railways. It's just an amazing display of discipline, and a systematic approach - it's unparalleled. I don't know any other country that does it in this way."

If anything, the chief inspiration for *Winner Take All* seems to have been Moyo's irritation with Western attitudes to Chinese growth.

"There is this obsession with China being a culprit," she agrees. "Even now, people will still say: 'Oh, the reason why the United States' economy is not doing well is because the Chinese are manipulating the exchange rate,' or, 'The Chinese have human-rights issues,' and, 'The Chinese don't do democracy, and the Chinese cheat.' You know, it's always about the Chinese, and no one actually takes a step back and thinks: 'Gosh, actually, it's our fault that productivity is declining. It's got nothing to do with the Chinese.'"

The hypocrisy of Western criticism is, she says, quite breathtaking. The West accuses the Chinese government of meddling in free-market capitalism, clean forgetting that US farm subsidy programmes and Europe's Common Agricultural Policy have condemned Africa's farmers to poverty. The US is perfectly happy to take China's money - more than US$1 trillion worth of government bonds - yet expects the emerging markets to say: "No, we don't want Chinese money because there's an issue of human rights."

The West complains that the Chinese are paying too much for commodities, instead of wondering whether China might in fact have grasped their true value. And the West has the nerve, she marvels, to accuse China of neocolonialism, failing to understand that "the rest of the world actually thinks what China is doing is pretty damn clever". It was the West that got rich by invading and plundering the rest of the world, whereas China is engaging with it on respectful, peaceful, generous terms.

"What the Chinese are trying to do - move a billion people out of poverty - is just an unheard-of thing in history. The fact that they have moved 300 million in 30 years is unheard of. It took Britain 156 years to double its per capita income.

It took America 57 years, Germany 65 years. It's taken the Chinese 12½ years."

Moyo stresses more than once: "I'm an economist, not a political scientist," and her writing is full of the maddeningly opaque jargon of commodity trading. Yet the book's fundamental message seems to be as much about the contrasting politics of Washington and Beijing as it is commodity prices.