



October 15, 2012

Dear Clients, Partners, and Friends,

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

| | <u>Sep 2012</u> | <u>Year-to-Date</u> |
|-----------------------------|-----------------|---------------------|
| Hong Kong Partners LP (net) | 2.7% | -1.6% |
| Hang Seng Index | 7.0% | 13.1% |
| MSCI HK Small Cap Index | 4.9% | 10.0% |

PartnersøNAV for Sept \$2.3155 after management fee, but before annual incentive fees of 15% on appreciation.

Thin trading volumes again prevailed in the Hong Kong stock market during September. Sentiment swung daily on the latest readings of the global economic crisis. For example, larger capitalized stocks were easily influenced, especially interest rate-sensitive property-related stocks, as when Fed Chairman Bernanke announced QE3 (the Hang Seng Index soared on the Fed announcement, gaining more than 3% in one day, but absent in the rally were many smaller capitalized shares where we focus our investment attention).

The market grinds higher under the central banksøstimulus programs, yet with the unprecedented impact of political risk hanging over the markets today, investor confidence is curtailed.

Last month, we were active visiting new companies, gleaning from mangers and executives their take on the economic landscape. At present, we are holding off buying any additional positions in our portfolios. The market has rallied 13% since early June so we are cautious (our cash holding is ~30% of total portfolio value).

This cash will be reinvested in either current holdings that have corrected (our holdings of strong balance sheet companies with above average growth prospects and low stock price valuations) or in new ideas we discover in our continuing company visits and analysis.

We wait to see how the fragile economic conditions today affect investor sentiment in the coming months before becoming fully invested. Hong Kong is an inefficient market, and with this cash buying power, we can take advantage of opportunities that may evolve (not that we like being on the sidelines, but itø comforting being able to take advantage of lower priced shares should sentiment suddenly swing negative again).

Slowing economies have enabled us to initiate partial positions this summer in two companies with strong *Warren Buffett* 'moats'; namely, outsourcing giant Li and Fung and IT distributor Digital China. Li and Fung has become the world's largest sourcing agent. The company provides a full range of services, an unrivalled position in the sourcing industry with a global footprint of 15,000 suppliers in 40 countries.

Digital China (861hk) has 12,000 channels within China to distribute IT global brand products. No other company can possibly replicate this network in China's diverse market. As a spin-off of giant PC manufacturer, Lenovo, Digital China's leading position to service major China utilities and government departments gives it an unparalleled advantage. We bought shares trading at \$12, down from a 52 week high of \$17, at a single digit expected price earnings ratio. Digital China is debt free.

We attended global sourcing giant Li & Fung's (494hk) first half financial results with management at the Grand Hyatt Hotel in Hong Kong. The company surprised the investment community by announcing lower than expected earnings, the first earnings decline we have witnessed since we began following the company in 1993.

In the early 90s, we bought shares when they traded at less than 10x expected earnings, no debt, when there was about HK\$800 million in revenues. With our cost at an equivalent of 30 Hong Kong cents per share (adjusted for splits), we held until 2007. We sold at \$25 after the company reported \$0.89 in trailing earnings per share, or a relatively high price/earnings ratio of nearly 30 times.

After the results announcement this summer, the shares dropped sharply. The company has grown to US\$21 billion in annual revenues and a market capitalization of US\$12 billion. The shares trade at 15 times estimated earnings of \$.80 per share for 2013.

More on the company given in the article following. We bought the cash-rich (US\$200 million cash on hand) shares following the announcement, alongside company insiders including the majority owners, the Fung family, who reportedly made open market purchase of around 20mn shares.

Using conservative estimates for these two holdings, we can project longer term. Digital China's earnings per share growth in the last 5 years has been 37.2% annually. If we project it will grow in the next 5-10 years at a 9.8% earnings per share growth rate and sell at its historic P/E of 12 times, the shares would exceed \$70. For Li and Fung, earnings have grown at 14.4% annually for the last 5 years (18% over the last 10 years), and the market is projecting 20 % annual growth for the next 5 years. If we project earnings to grow at a 10% projected rate for the next 10 years (and using its lowest historic P/E multiple of 19 times versus its average of 31 times P/E), the shares would sell at \$118. We would accrue a >20% compound annual return under these scenarios with each of these positions.

Suspended holding Chaoda Modern Agriculture made an announcement on September 28th. The Company has not yet formally appointed its auditors and the process of

identifying a suitable replacement to fill the vacancy is continuing. The Company is unable to predict at this stage the date by which the appointment can be made but will endeavour to make an appointment as soon as practicable and make an announcement when the appointment is made. Once the appointment of the Company's new auditors is made, an audit of the Group's financial statements would be carried out with a view to, among others, publishing all outstanding financial results and reports of the Group for the two financial years ended 30 June 2011 and 2012 together with the six months ended 31 December 2011 as soon as practicable.

We wait for further news.

Sincerely,

Brook McConnell

President

Email: brook@south-ocean.com Website: www.south-ocean.com

Hong Kong

August 20, 2012, 1:31 p.m. ET

Li & Fung Faces Threat as Retail Supplier

KATHY CHU

Li & Fung supplies American retail giants like Walmart and Target, but amid lackluster growth around the globe it's looking for more business in Asia. The WSJ's Deborah Kan speaks to Li & Fung's President Bruce Rockowitz.

HONG KONG- For the past century, [Li & Fung Ltd. 0494.HK 0.00%](#) has been supplying everything from shoes to baby clothes for such global retailers as [Target Corp. TGT -0.78%](#) and [Wal-Mart Stores Inc. WMT +0.43%](#). But after decades of rapid expansion, the company is logging shrinking profit margins.

Now, an even greater threat looms: retailers working directly with factories and cutting out middlemen like Li & Fung.



Singer Coco Lee and Li & Fung CEO Bruce Rockowitz addressed the media at the couple's wedding in October.

The company's shares this month have posted their biggest drop since listing on the Hong Kong Stock Exchange in 1992, and several brokerage firms have downgraded the stock.

Despite making nearly two dozen acquisitions in the past 18 months, Li & Fung's revenue rose only 4% in the first half and expenses rose sharply, indicating that some of the companies Li & Fung acquired may be underperforming. Analysts estimate that the company's organic earnings, which excludes results from acquisitions, have declined.

Chief Executive Bruce Rockowitz blames the company's weak performance on a challenging global economy rather than internal operating problems.

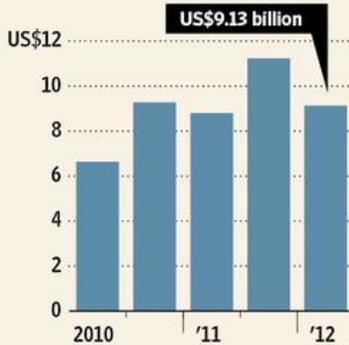
"When the world is bad, of course your organic growth is going to slow down," says Mr. Rockowitz, a 53-year-old former tennis instructor from Canada. "If the world improved a lot, and we were still performing at a lower organic rate, then that's [a problem]. But that hasn't happened."

Li & Fung's original business model was to contract with factories to manufacture goods for retailers, but the company long ago expanded into a one-stop shop: It now designs, markets and transports products as well.

A weak global economy has given Li & Fung the opportunity to buy cheap assets, which helps offset slowing organic growth, says Mr. Rockowitz, who cruises around Hong Kong in a blue two-door Bentley with a license plate that says "Rock 8," a reference to his lucky number. He married Asian pop star Coco Lee last year in a ceremony attended by American singer-songwriter Bruno Mars and other celebrities.

Li & Fung

Half-year revenue, in billions



Sources: the company; SIX-Telekurs via Factiva

Daily share price



The Wall Street Journal

Mr. Rockowitz says he expects profit margins in the company's distribution business, which are at a record low, to recover next year as raw-material costs ease and the company shifts jobs to countries such as China and Bangladesh from higher-cost countries.

"We feel good" about Li & Fung's ability to increase core operating profit to \$1.5 billion in 2013 from \$726.1 million in 2010, he says.

Barclays analyst Vineet Sharma believes the company will miss the target "by a significant margin," however.

But the main challenge facing Li & Fung is maintaining its role as a middleman.

"My biggest concern is that the margin deterioration we saw was not just cyclical but could be structural," says Gabriel Chan, director of Asian equity research at Credit Suisse. The bank downgraded Li & Fung's stock to "underperform" this month. "Li & Fung has to do more and more to keep their customers," which could hurt profit margins, Mr. Chan says.

Customers including Wal-Mart and children's apparel companies [Carter's Inc. CRI -1.44%](#) and Gymboree Corp. have said they plan to obtain more of their products directly in coming years.

But even when retailers decide to source directly, they will still need an intermediary to manage logistics, communications and quality checks with the factories, Mr. Rockowitz says.

He says retailers aren't moving away from Li & Fung; indeed the company has signed agreements to source products for retailers including Target Australia and Wal-Mart. Li & Fung gets 62% of its revenue from the U.S., 18% from Europe, and the rest from Canada, Asia, Central and Latin America, South Africa and the Mideast.

Li & Fung recorded an operating loss last year from its 2010 sourcing deal with Wal-Mart, a trend that UBS analyst Spencer Leung says will likely continue.

Large retailers often use a mix of direct sourcing and working with intermediaries, and as they grow, migrate toward the former to boost profits, says Peter Brown, vice chairman of Kurt Salmon, a retail consulting firm. The need to design, manufacture and get products in the store quickly— a fast-retailing concept popularized by chains such as Inditex Group SA's Zara— also boosts the appeal of direct sourcing, he says.

When the global economy improves, the threat of retailers sourcing directly will increase, says Credit Suisse's Mr. Chan. During a weak economy, retailers may not want to pay the upfront costs for infrastructure and offices that allow them to source directly.

Mr. Rockowitz says Li & Fung will change with the times, if necessary.

"We're doing more for our customers today, not less," he says. "No one can say what's going to happen in the future, but we look at our business as a drumbeat, and we look every three years to see if we need to change."

Write to Kathy Chu at kathy.chu@wsj.com