



September 13, 2016

Dear Clients, Partners, and Friends,

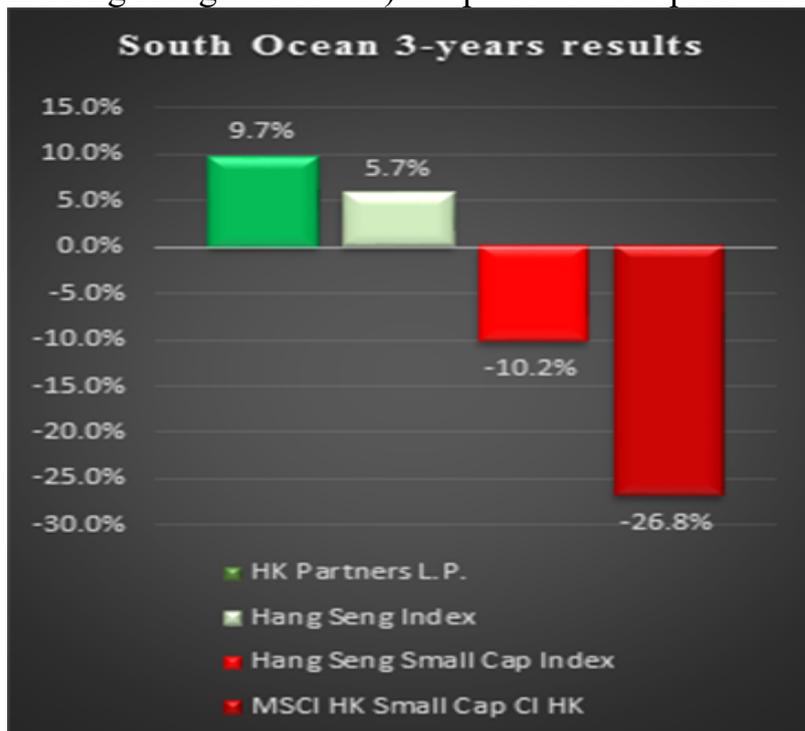
The results for South Ocean Management’s Delaware LP, Hong Kong Partners’ L.P., before incentive fees, were as follows:

| | <u>Aug 2016</u> | <u>Year-to-date</u> |
|---------------------------|-----------------|---------------------|
| Hong Kong Partners LP | 2.5% | -3.0% |
| Hang Seng Index | 5.0% | 4.8% |
| Hang Seng Small Cap Index | 5.7% | -6.7% |
| MSCI HK Small Cap Index | 2.7% | -8.8% |

Partners’ NAV \$2.9172 after management fee and provisions, but before annual incentive fees of 15% on appreciation.

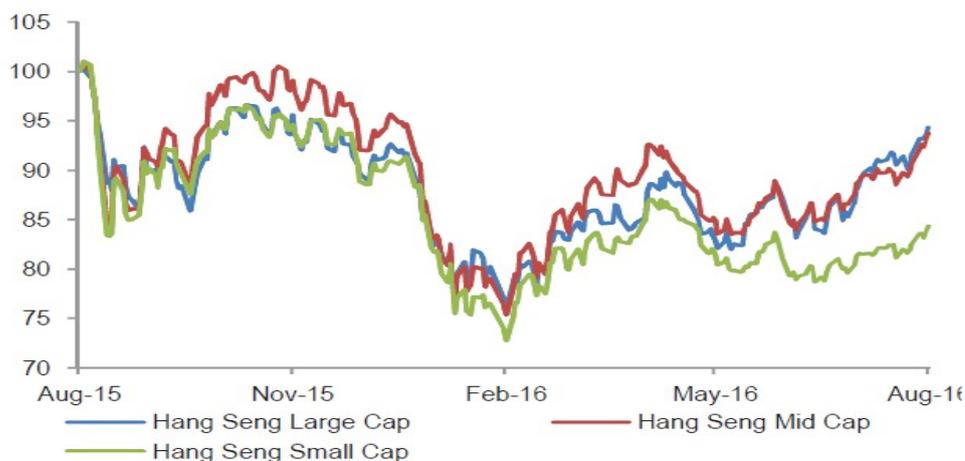
"Getting to the top is optional. Getting down is mandatory." Cardinal principle of Ed Viesturs, only American to have climbed all 14 of the world’s 8,000 meter mountain peaks, 5th to do without oxygen.

South Ocean Management’s intrinsic value driven investment process seeks undervalued stocks of companies listed in Hong Kong with operations geared towards China. Our primary focus of investing is in quality, under-researched and under-followed small/mid cap stocks (a sector that has been out of favor in Hong Kong for a while) has proven to out-perform over time:



The small cap sector (Hang Seng small cap index) has dramatically underperformed the larger capitalized stocks this year, as seen in the following chart...

Figure 18: 1-year performance of Hang Seng Large, Mid and Small-cap index



Source: J.P. Morgan Equity Derivatives Strategy, Bloomberg

...and, yet, is playing catch up today.

On the macro front, China's second quarter GDP growth of 6.7% remained the same as the first quarter this year. Consequently, China 'hard landing' fears have subsided. Unlike most world economies, China's central bank (the People's Bank of China) has room to cut its 1-year lending rate (which stands at 4.35%) and cut its banking reserve requirement ratio (RRR) should further stimulus be in order.

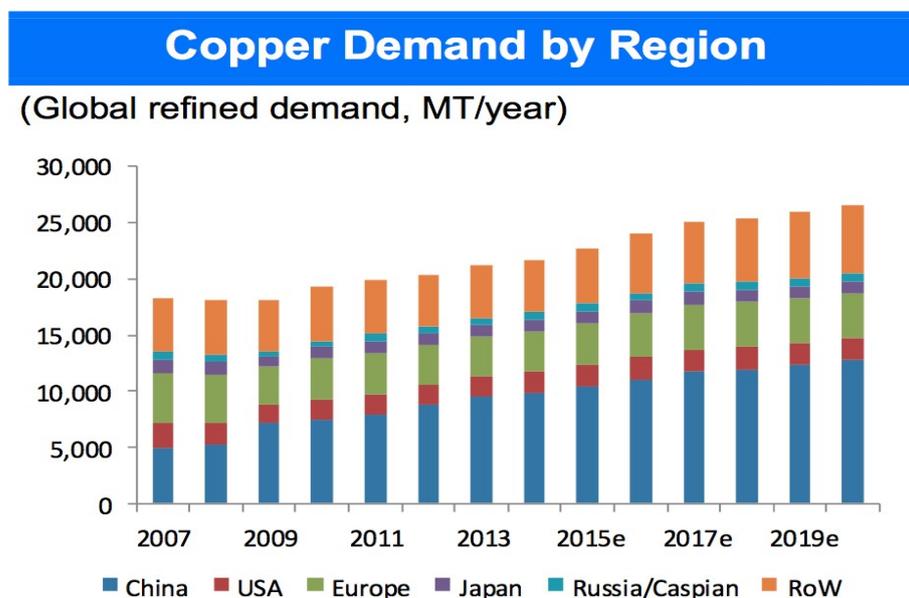
On the more micro level, China is going green and a majority of our small/mid capitalized holdings are aligned with this trend. As mentioned last month, our top holdings are environmentally oriented: solar, wind, water and energy-related/saving products. During August, our water and solar/wind holdings performed well, with price gains ranging from +9 to +13%. Our overall performance was muted by one holding's lower-than-anticipated earnings report (Jiangnan Holdings, code 1366hk, 3.6% holding) and sidelined cash (~16% of total market value).

In August, interim earnings announcements in Hong Kong’s stock market were notably disappointing as China’s slowing economy hit bottom lines. Our holding in power cable manufacturer Jiangnan Holdings was pressured after a lower than expected earnings report and the shares were sold down in the last two days of the month.

We decided to hold the position, determining the company is well-placed in a dynamically growing industry. The company is actively securing more business with grid corporations in China and exploring opportunities overseas arising from China’s “One-Belt-One-Road” initiative. A 21% average decline in the price of copper during the period was mainly responsible for the earnings miss even as sale volumes increased.

As a leader in high voltage power cable manufacturing, Jiangnan operates on a cost-plus basis when tendering for bids for State Grid contracts (the red metal is the predominate material cost). China’s State Grid is spending 400 billion RMB or US\$65 billion annually to construct a second power grid in China (the International Energy Agency estimates the mainland will need to spend more than US\$4 trillion until 2040 to overhaul the way it transmits and distributes electricity).

China continues [buying](#) most of the world’s production of copper to meet its growing electronic needs:



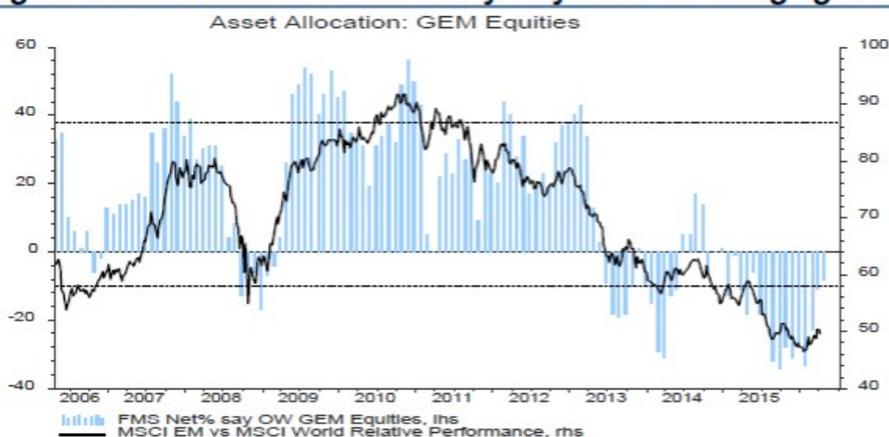
Source: WMBH, Morgan Stanley Commodity Research estimates

As of this writing, Jiangnan's shares have recovered almost one-half of the sudden month-end price collapse. Nonetheless, our August overall results were held back by the share decline.

The Hang Seng Index has rallied, post Brexit. The abrupt change to a positive (from a negative) outlook was partially due to the belief that Brexit would lead to a diversion of funds to Hong Kong from Europe. In August, the Index rose 936pts (3.7%) after a 5.3% increase in July. A long awaited reform announcement from China of the new Shenzhen/Hong Kong stock connect, to be implemented later this year, bolstered investors' confidence along with significant inflows of funds emanating from Mainland investors seeking better returns in the SAR market.

The (unexpected) rise of prices lately is not surprising as Hong Kong's bourse is a cheap, neglected and under-owned market. In general, fund managers are more than 55% underweight Emerging Market equities relative to developed market equities, as shown in this chart:

Figure 12: Net % Asset Allocators say they are O/W Emerging Market equities



Source: BofA Merrill Lynch Global Fund Manager Survey

As we have been saying for some time, as China further opens its stock market to foreign investors, there is much under-allocation that will change course. China A-shares becoming included in the MSCI indexes would be one catalyst for this change.

As more and more Hong Kong stocks rise, many investors/traders who've been sitting on the fence are now getting nervous. These under-invested portfolio managers may start chasing returns, resulting in a possible melt-up run in the markets (Hong Kong is, and has always been, a massive momentum trading market).

Our portfolios are concentrated in fundamentally strong companies, and our returns should benefit in any melt-up situation. Nonetheless, we have raised some cash, and will probably give up a few percentage points of return for the chance to be opportunistic with our sidelined cash if there's a shock or sudden dip (overvalued US stock prices, elevated bullish/ebullient sentiment...



... a lack of fear and complacency are worrisome conditions for the near



term).

We own solid companies with encouraging prospects and are prepared with a little buying power for any opportunities that may develop. If clearer trends evolve to further our ascent, or conditions deteriorate where its mandatory to descend, we think we are positioned properly.

Our weighted average P/E on this year's expected earnings is 9.2 times, with expected earnings per share growth (2015-2017) of 43.3%.

Sincerely,

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