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

August 10, 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:

	Jul 2016	Year-to-date
Hong Kong Partners LP	1.3%	-5.4 %
Hang Seng Index	5.3%	-0.1%
Hang Seng Small Cap Index	0.4%	-11.8%

Partners' NAV $2.458 after management fee and provisions, but before annual incentive fees of 15% on appreciation.

> As in all other activities that emphasize price movements first and underlying values second, the work of many intelligent minds constantly engaged in this field tends to be self-neutralizing and self-defeating over the years. The investor with a portfolio of sound stocks should expect their prices to fluctuate and should neither be concerned by sizable declines nor become excited by sizable advances. He should always remember that market quotations are there for his convenience, either to be taken advantage of or to be ignored. He should never buy a stock because it has gone up or sell one because it has gone down. He would not be far wrong if this motto read more simply: "Never buy a stock immediately after a substantial rise or sell one immediately after a substantial drop."
> — **Benjamin Graham**, **The Intelligent Investor**

South Ocean Management's Hong Kong Partners LP has been investing in small/mid cap, Hong Kong-listed stocks, with earnings geared towards China, since our launch in 1993.

Last month, reduced concerns of a US interest rate increase after diminished Brexit worries sent Hong Kong large caps, especially the property sector, up strongly:

Name	1m %	YTD %
HANG SENG INDEX	7.12	-0.11
HSI-PROPERTIES	13.78	10.34
HSI-FINANCE	5.99	-8.15
HANG SENG C S C (Small caps)	1.91	-11.27
HANG SENG C E I (H-Shares)	4.52	-7.27
HANG SENG C M C	3.51	-6.55

(mid caps)

Non property-related stocks, such as small/mid-cap stocks and the China H-share industrial sectors, lagged in July, and have declined in 2016.

Because Hong Kong's dollar is pegged to the US$, Hong Kong interest rates have to follow US interest rates. Therefore, interest rate movements impact the blue chip index massively. The large cap Hang Seng Index (US$1.9 trillion market value) is weighted 61.6% in Financials (or interest-rate sensitive property and banking names). Conversely, the Hang Seng small cap index (US$170 billion market cap) is weighted 22% in Financials.

We own no financial-sector stocks in our portfolios. I recognize, this may seem a bit odd; why be in Hong Kong's stock market if we're not involved with the major asset class here - property? That's akin to being based in Vancouver and not heavily involved with small metal/mining stocks, or based in Silicon Valley and not being involved with tech companies, in Detroit and no auto stocks, New York and no finance or in Houston and not involved in oil.

Our reasoning when analyzing whether to own Hong Kong property stocks is two-fold: as asset plays, we only buy when they sell at steep discounts to NAVs (Net Asset Values) and only if the physical market is in a steep decline as well. In the past, we did own several property/developer plays (bought during the SARs-hit, 2003 market bottom), but rising property stocks today we avoid. Rather, the China growth companies, which are out of favor, we seek to own (note Ben Graham's rules above). These companies are the primary beneficiaries of China's progress, which is our rational for being based in Hong Kong: owning fundamentally strong, niche-growth companies with products/services geared towards what China needs!

For instance, over one quarter of our portfolio (28.9%) is invested in leading environmental stocks: solar, wind, water and energy-related/saving products. As a group, they sell at an average of 10.1 times this year's expected earnings (ranging from 5.7 to 13.7 times) with an average expected 58.4% earnings per share growth (2015-2017).

Our largest holding, leading smartphone metal casings manufacturer, Tongda Holdings, (9.5% holding, US$1.2 billion market cap, code 698hk), was just included in the Asia's 200 Best Under A Billion – Forbes list (shares have risen lately to just over a billion $ market cap). On expected earnings per share growth (2015-2017) of 67%, Tongda's shares sell at 9.7 times this year's expected earnings.

The interim results reporting season will be the focus in August for a majority of Hong Kong companies. We are optimistic on the potential for all our sound holdings.

Sincerely,

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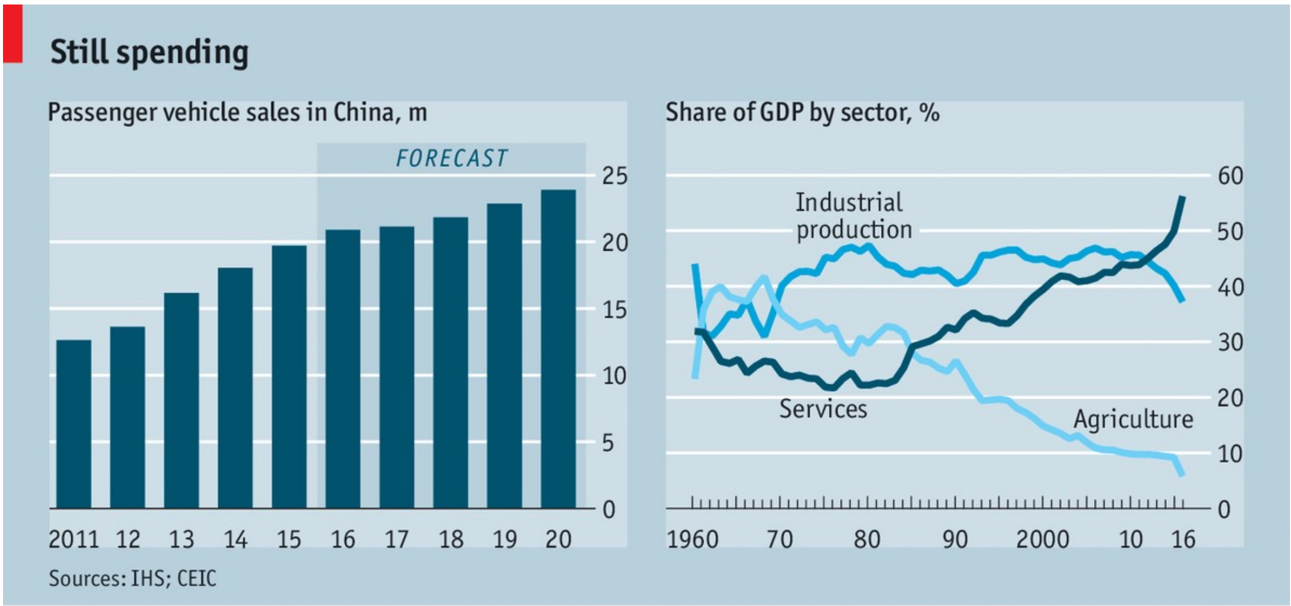
The advent of the America's consumer society of the 1950s and 60s gave rise to the preeminence of the American economy. That's what is just starting in China today.

China's consumers **Still kicking**

Despite China's economic slowdown, consumption is resilient

Apr 30th 2016 | BEIJING | From the print edition

IF YOU believe that China's economy is in trouble and that Chinese consumers are clinging tightly to their yuan, a visit to a local car dealership may make you think again. China has roared past America already to become the world's biggest car market. In March sales of passenger cars zoomed again, by nearly 10% year on year. Shiny sport-utility vehicles (SUVs), the hottest, shiniest items at this week's biennial Beijing Auto Show (pictured), did even better: sales jumped by 46% in March from a year earlier. The car market is forecast to keep growing briskly for the rest of this decade (see chart).



Economist.com

The Chinese consumer is flashing his wallet elsewhere, too. China's box-office revenues shot up by nearly 50% on a year earlier in 2015, to $6.8 billion. Cinema operators led by Wanda Group, an ambitious local conglomerate that recently bought Hollywood's Legendary Entertainment, have poured money into expansion; the number of screens across China has been rising at 36% a year since 2011.

After years of expansion, the smartphone market is peaking. Some firms still thrive: China's Huawei, a telecoms giant, predicts that revenues from its consumer-devices division will rise by about 50% this year. But Xiaomi, an innovative electronics firm once seen as China's answer to Apple, is losing steam. Apple itself announced weaker results on April 26th (see article). Revenues from sales in greater China fell by 26% year on year. As the market for devices matures, however, consumer spending is shifting to services: data usage has grown at triple-digit rates since 2012.

The unrelenting march of e-commerce continues. In 2010 online shopping accounted for only 3% of total private consumption, but it now makes up 15%. Alibaba, which processes more sales on its e-commerce platforms than eBay and Amazon combined, saw annual Chinese revenues grow to 63 billion yuan ($9.7 billion) in 2015, a rise of nearly 40% compared with a year earlier. JD, its main local rival, saw revenues leap by nearly 58%.

Chinese are still spending heavily abroad. Their international tax-free shopping shot up 58% last year, according to a new report from Global Blue, a big operator of duty-free shops. Overall, Chinese tourists spent $215 billion on outbound travel last year, a rise of 53% on the previous year. Ctrip, a big online travel firm partly owned by Baidu, a Chinese internet search giant, saw its revenues jump by nearly half last year, to 10.9 billion yuan.

As with cars, screens and travel, so with consumption generally. All retail sales across the economy, adjusted for inflation, rose by 9.6% during the first quarter, compared with the same period a year ago. The services sector, which caters to the growing demands of the middle class, has been rising by 8% a year in real terms since 2012 (see chart). Services made up 57% of economic output in the first quarter; electricity consumption in services rose by some 10%, but was flat for industry.

Not every market is as bouncy as it once was. A cooling economy and an official anti-corruption drive have squeezed luxury goods, sales of which fell by 2% year on year in 2015, to 113 billion yuan. But some firms are doing well. Rémy Cointreau, a premium liquor brand offering tamper-proof bottles on the mainland ("near field communications" tags tell your smartphone if the booze has been diluted), saw global revenues rise by nearly 10% last quarter and credited "improving trends in greater China". According to Bernard Arnault, the boss of LVMH, a luxury goliath: "Analysts underestimate the Chinese economy... the fundamentals are good. Household spending is still increasing."

The two Chinas

Can consumption remain resilient given the troubles of the country's state-dominated industrial economy, ranging from vast overcapacity to record levels of debt? One temporary source of comfort is the fact that the state sector may now itself be stabilising, thanks to a massive, debt-fuelled government stimulus. But greater reassurance comes from the fact that even a big shakeout in heavy industry would be unlikely to derail the Chinese consumer. By one estimate, if 30% of capacity is slashed across China's most bloated state industries, perhaps 3m workers will lose their jobs over the next three years. But thanks largely to the private sector, the country created 64m jobs between 2011 and 2015, with more than 13m emerging in the past year alone.

The dynamism of the mostly-private consumer sector comes not from stimulus, argues Andy Rothman of Matthews Asia, an investment firm, but from strong income growth and low household debt. (Chinese household debt stands at about 40% of GDP, roughly half the level seen in America.) Real urban incomes rose by 5.8% in the first quarter. Willis Towers Watson, a consultancy, estimates that white-collar salaries are now significantly higher in China than in South-East Asia. That fuels a bristling optimism. A recent study by McKinsey, a consultancy, found that 55% of consumers in China are confident that their incomes will rise significantly over the next five years.

Many big firms seem willing to look past current clouds over China's economy to brighter days ahead. Pepsi, an American snack-food firm, opened its first Quaker Oats manufacturing plant on the mainland in October, and has launched oat-based dairy drinks to cater to local tastes. It even hopes to introduce Pepsi-branded smartphones. McDonald's, an American hamburger chain, wants 1,250 outlets in the mainland over the next five years on top of the 2,200 it operates already.

America's Walt Disney, an entertainment colossus, is set to open Shanghai Disneyland in June. The $5.5 billion theme park is its biggest investment outside Florida. Keen to experience such wondrous novelties as Peking-duck-topped, Mickey-Mouse shaped pizza, Chinese families are now eagerly snapping up entry tickets online. Starbucks, an American coffee chain, plans to add 500 outlets this year in China, including one at the entrance of the new Disney park. Howard Schultz, its boss, predicts it will be "Starbucks' highest-grossing retail store overnight".

Firms such as these are betting on the continued rise of the affluent middle class. By 2020, the number of households earning above $24,000 per year is expected to double to 100m, making up 30% of all urban households. They are also betting on the frivolity of the free-spending young. Consumption is rising at 14% a year among under-35s, twice the level of frugal oldies. But above all, they are betting on the law of large numbers. A joint study, by the Boston Consulting Group, another consultancy, and AliResearch, the research arm of Alibaba, predicts that even if economic growth falls to only 5.5% per year (well below official claims of nearly 7% a year now), China's consumer economy will expand over the next five years by some $2.3 trillion. Despite the deficiencies in economic forecasts, that incremental gain would be bigger than the entire consumer economy in Britain or Germany today.

From the print edition: Business