

PENDO LLC



THE VALUE INVESTOR

International Core Value Strategy Commentary Q1 2010

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Has The Global Bull Become The International Snail?

After robust returns across the globe last year, 2010 is off to a somewhat slow start. Perhaps it is exhaustion from last year's grueling battles, with markets catching their collective breath, trying to find their feet in front of them. International indices for the quarter mostly range from between up 1% to down 5%, with a trading range between plus 3% and minus 11%. One slight exception is Brazil. The Sao Paulo-based benchmark Bovespa index reached a twenty-two month high on March 31st, and finished the quarter up 2.6%.

Last year's earnings announcements are mostly completed; some positive and some negative. As long-term investors, earnings season is usually not as life-or-death relevant to us as it seems to be to the barkers on the cable news channels. That being said, after these last two years, it is with perhaps a sigh of relief that our companies have all reported, and we believe are now heading toward continued improved results. As can be expected, some earnings were better than others with some of our general observations being that energy companies reported earnings declines due to a 38% decline in the average price of oil (as measured by the benchmark West Texas Intermediate, or WTI). Earnings from our exchanges increased modestly despite massive gains in world markets, primarily due to low trading volume. While we are always optimistic of our companies' long-term prospects (3-5 years), we feel that our individual companies are very well positioned to do well going forward in the near-term (6-12 months) as well. Many of them have a much stronger balance sheet than a year ago, still trade at attractive multiples, show increasing earnings, and have sustainable business models and competitive advantages, with some even paying healthy dividends.

Two companies that had a large positive impact on our performance are **Sino Biopharmaceutical** and **Sichuan Expressway**. Sino Biopharmaceutical's stock price increased 24% during the first quarter. Although we find no material reason for this short-term bounce, it may be due to China Life Insurance Company taking a 5% position, or the fact that the Chinese government has been actively discussing its future healthcare plans. Just as we don't overreact to the short-term negative swing in a stock price, neither do we overreact to a positive short-term swing. It is our opinion that Sichuan Expressway has been deeply undervalued for quite some time, while continuing to compound earnings internally at a very high rate. Valuation discrepancies like this normally correct themselves with time as they are discovered by the investment community.

Two companies that had an outsized negative impact on our slight underperformance versus the market this quarter are **Hong Kong Exchanges and Clearing** and **Tsingtao Brewery**. In 2009, the stock prices of these companies were up 89% and 167%, respectively. As long-term investors, we do not believe that short-term fluctuations in stock prices are anything but noise. However, we feel that some profit taking may have been the main cause for the decline in the prices of these two companies. In the long-run, our opinion on these companies has not changed. We still believe that for us to own Tsingtao today is comparable to having owned Budweiser in the 1940s, possibly even better. We continue to believe that the Hong Kong Stock Exchange is a very attractive investment that will benefit greatly from a disproportionate increase in IPOs and volume relative to other bourses. We believe that the volume will not just increase organically, but be driven by upcoming changes in the Chinese regulatory environment such as the inclusion of indices, short-selling, the increase in float of government-owned companies, and the general growth in the region versus the more developed economic regions.

During the quarter, we added two new holdings: **Chow Sang Sang** and **GZI Transport**. We raised funds for these purchases by selling and reducing **London Stock Exchange**, **Deutsche Bank Agricultural Shares**, and **Commercial Bank of China**. None of these investments are unattractive; we just feel that our new investments provide us with a more attractive risk/reward profile and diversification of the portfolio holdings. Here is a list of our new holdings, and others that we feel are worthy of mention:

Chow Sang Sang (HKEx: 116; 3/31/10: \$1.83) is a Hong Kong-based holding company that primarily operates a high-end jewelry retail chain in Greater China. Founded in 1934, the company has lately been focused on expanding its presence in Mainland China. It now has 143 stores on the Mainland, 29 which were opened in 2009, and 77 spread out between Hong Kong, Macau, and Taiwan. Sales from its Mainland shops now account for 37% of retail sales, up 106% since 2006. In 2009, sales in Mainland China increased by 25% versus 2008. During the last five years, the company's average return on equity was 11.9%, average net income margin was 4.5%, and its net income grew at a 21% compound annual growth rate. As the company's Mainland retail business becomes an increasingly dominant part of the company's sales, we expect profit margin, return on equity, and growth rate to exceed historical averages. The company is well-financed with cash exceeding debt. It currently trades at 10.8x trailing earnings and pays a 5.9% dividend yield. We feel that although this company has a lower margin and return on equity than our "typical" investment, its price provides us with an attractive entry point in which to participate in the growing Chinese luxury consumer market. The company reported that its items priced above HK\$50,000 (\$6,450) rose by 75% in 2009, a reflection of the increase in the wealth of the population, along with a developing trend toward (state encouraged) consumerism. The company should continue to benefit from the growing income per capita and the additional stores.

GZI Transport Limited (HKEx: 1052; 3/31/10: \$0.51) is a Chinese toll-road developer and operator, primarily operating in the Pearl River Delta area in the Guangdong Province. As such, the company collects tolls from traffic on its 12 roads and 2 bridges. Similar to other Chinese toll-roads, it also has sales from various auxiliary operations such as billboards and rest areas. Guangdong Province is on the southern coast of China, and thus readily accessible for the transportation of goods. Guangdong is where China created its first three Special Economic Zones (SEZs) in 1979. The SEZs were created in order to encourage trade, and to attract foreign investments through relaxed business regulations and advantageous tax incentives. Guangdong is therefore quite developed and could possibly be considered mature. However, with little capital expenditures, a well capitalized balance sheet and a net cash position, any increase in traffic will benefit the company's profits directly. It trades at 0.8x book value, 11.9x 2009 earnings and pays a 4.0% dividend yield. Other Hong Kong-listed toll-road operators trade at

approximately 1.5x book value and 14x earnings. We feel that the risk/reward profile of this company meets our investment philosophy and therefore initiated a position. This company should, theoretically, trade at par with its competitors; future upside will come from steadily increasing traffic, which is expected to continue unabated due to the huge increase in automobile ownership and usage.

Companhia Energetics de Minas Gerais, or CEMIG (NYSE: CIG, \$16.64), is Brazil's largest integrated utility providing electric power generation, transmission, and distribution. Present in 20 states and Chile, the company is the largest consolidator in the industry. Approximately 98% of the company's 6754 megawatts of capacity is renewable; primarily hydroelectric power. Based in the state of Minas Gerais, where most of Brazil's large industrial companies reside, it is 51% controlled by the state's local government. The company is well financed with a 40% debt/capital ratio, and less than 3% of its debt being denominated in US dollars. In 2009, the company had a net income margin of 17% and a return on equity of 20%; both slightly below the last five-year average. Based on their sustainable business model, a high return on equity and high barriers to entry, along with its healthy balance sheet, we feel that this company meets our investment criteria. The company trades at 9x earnings and pays a 4.9% dividend yield. We believe that the company will benefit from a growing GDP and population, leading to an increase in Brazil's standard of living, combined with an increase in industrial demand and production.

CNOOC LTD., or China National Offshore Oil Company (HKEx: 883; NYSE: CEO, \$165.08), is China's largest offshore oil and gas exploration and production company. The company is authorized to cooperate with foreign partners for oil and gas exploration in China's offshore areas. It has four oil production areas offshore China, as well as offshore oil facilities in Indonesia, and certain upstream assets in regions such as Africa and Australia. CNOOC's annual reserve replacement ratio was 163% as of December 2009, the fifth largest in the world following Canadian Natural Resource (1,020%), EOG (364%), Devon (286%), and XTO (192%). In 2009, it increased net production by 17.2% to 227.7 million of BOE. Going forward, it plans to increase production by 20% this year, followed by a 6-10% increase per year thereafter. The company is well financed, trades at 10x 2010 estimates, and pays a 3.1% dividend yield. We feel that as a government-owned company, CNOOC and some of the other Chinese energy companies will be the greatest beneficiaries of the increase in energy demand from China. We also believe that it is going to be very hard to develop alternative fuels that will have a substantial impact on the demand for oil for the foreseeable future.

GlaxoSmithKline, Plc (NYSE: GSK, \$38.52) is a UK-based global pharmaceutical and consumer products company. It specializes in "annuity" drugs that treat chronic conditions and therefore need to be taken for the rest of the patient's life. Founded in 1935, the company operates all over the world. Over the last few years, it has been working on diversifying away from its dependency on white pill/western markets, which now accounts for only 30% of sales, down from 36% in 2008. It has been increasing its presence in generics, Emerging Markets and Japan. The company made nine acquisitions in 2009. Sales in Emerging Markets increased by 20% in 2009, and now account for 10% of total revenue. At the same time, the company has been actively reducing costs by streamlining its operations and reducing its workforce. The company is well financed, and currently trades at 8.8x 2010 earnings estimates with a 5.1% dividend yield. We believe that the Emerging Market pharmaceutical business will provide out-sized returns, and feel that participating through a large, stable, and developed multinational expert such as Glaxo is a very cheap way to participate in the future growth of the pharmaceutical arena.

We at Pendo LLC hope that this review is helpful to you, and will better enable you to understand our thinking and strategy.

Please feel free to call and speak to us directly at 212.880.6446. We are sure that you must be every bit as concerned about your financial well-being as we are, and we look forward to hearing from you.

Sincerely,

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