

DaltonInvestments

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Ivey Business School
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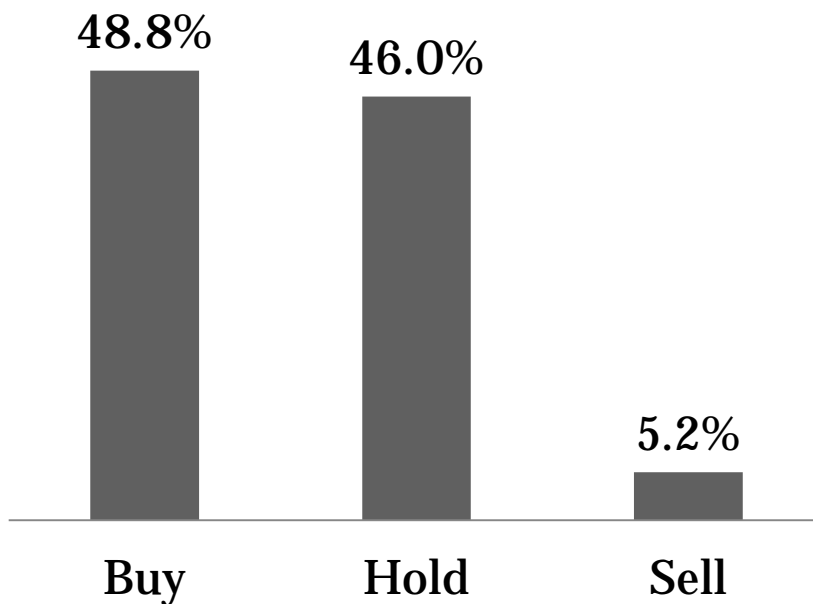
What's wrong with this picture?



Misalignment of Interests

Sell side analysts

S&P 500 Analyst Ratings



Source: FactSet, October 2013

- Brokers generate revenues from investment banking commissions
- Investment banking clients (corporations) benefit from bullish ratings
- Only 5% of S&P 500 company research reports are sells

Misalignment of Interests

Brokers

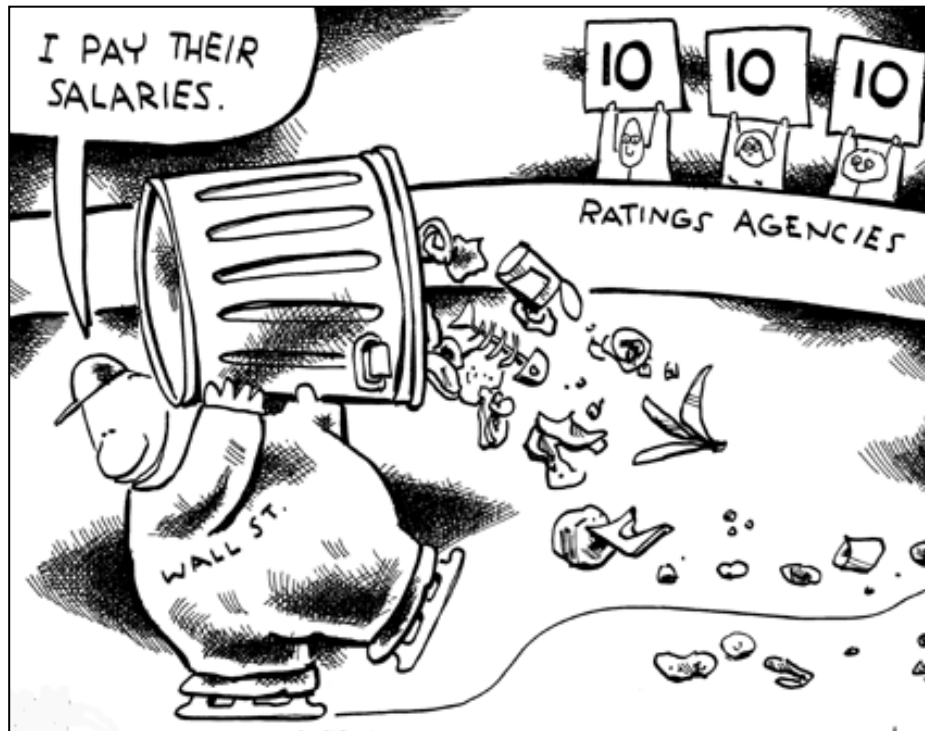


- Brokers generate commissions based on trading turnover
- The incentive is to maximize transaction volume
- Investors want the best investment ideas

“I know you purchased the stock at \$50 and now its \$10, and they filed for bankruptcy. But lets not read too much into that”

Misalignment of Interests

Rating Agencies



- Investors want independent, objective ratings for bonds
- Ratings agencies are paid by the companies whose bonds they are rating
- In 2007, more than half of newly issued mortgage-backed securities were rated AAA*

*Source: Milken Institute

Misalignment of Interests

IPOs

Company *	% price change on day one	% change since listing
Sinopec Engineering	-0.38	-3.05
Chinalco Mining Corp International	-6.29	-25.71
China Harmony Auto	-16.12	-12.83
Wuzhou International	5.74	0.00
PanAsialum	-13.08	-44.07
Termbray Petro-king Oilfield Services	26.83	40.85
Time Watch Investments	2.22	-40.74

- Issuing companies want to maximize capital raised
- Investment banks want to maximize commissions
- Investors want a favorable price, but IPOs tend to be overpriced and underperform

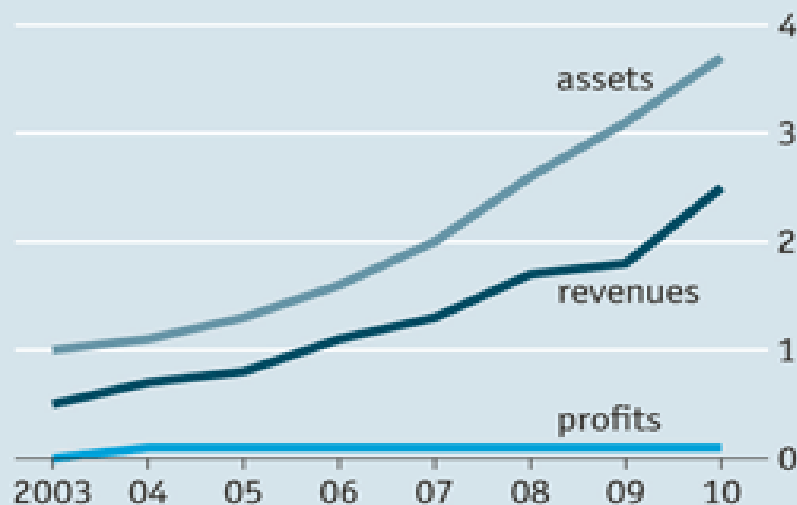
*Selected from top 10 HK-listed IPOs of 2013 by market capitalization
Source: South China Morning Post, November 2013

Misalignment of Interests

State-owned enterprises

Vast power; puny profits

China's state-owned enterprises':
\$trn

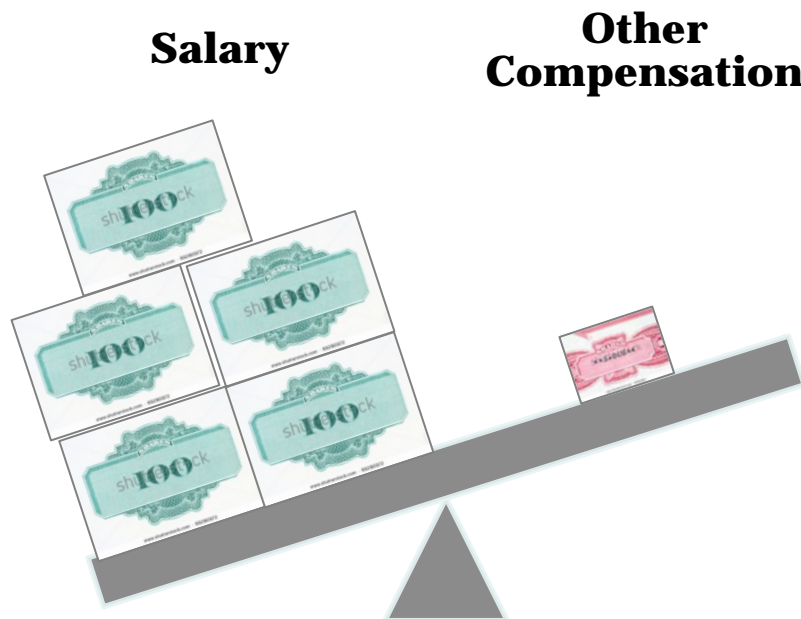


Source: SASAC

- An entity created by a government to undertake commercial activities on behalf of the state
- Management's interests tend to be more aligned with politicians than with shareholders
- Objectives other than maximizing profitability; ex. maintaining employment, growing asset base

Misalignment of Interests

Japanese *keiretsus*



- Japanese conglomerates with complex holding structures across multiple subsidiaries
- High inheritance tax in Japan dilutes family ownership
- Management receives high cash compensation but little performance-linked compensation

Alignment of Interests

No incentive for breaking form



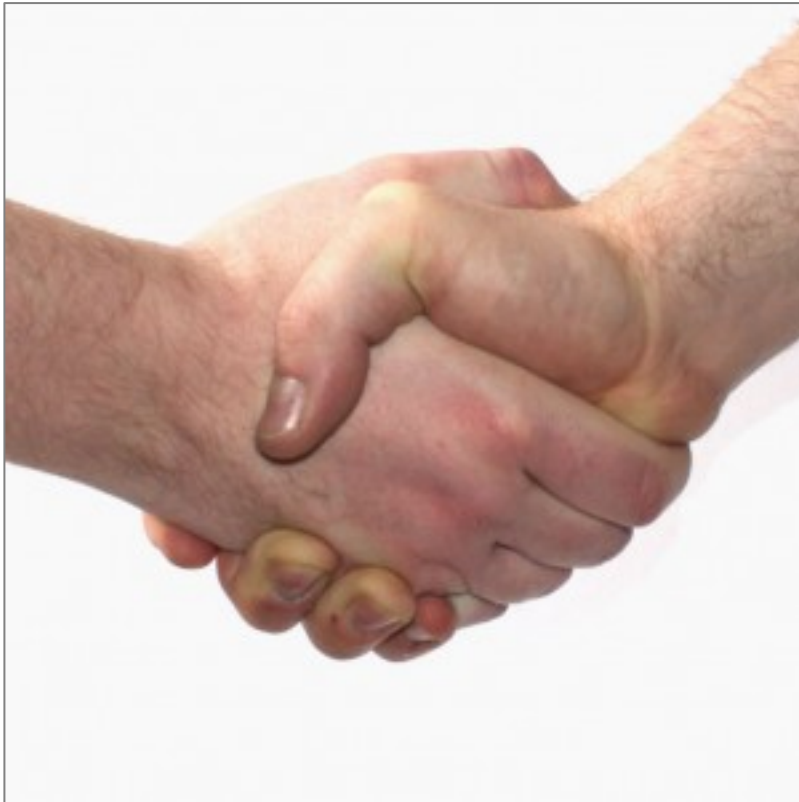
Alignment of Interests

**Individual incentives
aligned with group**



Alignment of Interests

“Skin in the game”



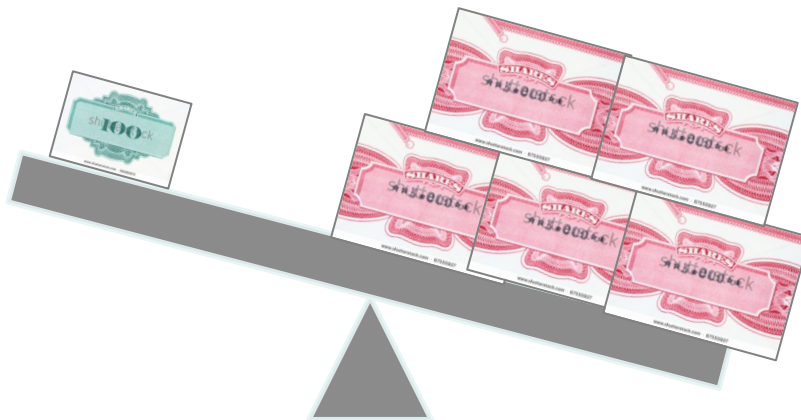
- To have "skin in the game" is to have incurred monetary risk by being invested in achieving a goal
- Warren Buffett used the term to describe a situation where management's interests are aligned with those of shareholders*

*Schroeder, Alice. *The Snowball: Warren Buffett and the Business of Life*

“Skin in the game” for executives

Salary

Company Shares



- Management should own at least 5x their annual salaries in company shares
- Management's stakes should represent the majority of their personal net worth
- Management = owner-operators

“Skin in the game” at Dalton



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- Investment professionals place 50% of their annual bonus into the firm’s funds
- Investment professionals’ best ideas are in the firm’s portfolios

Alignment of Interests

Family businesses

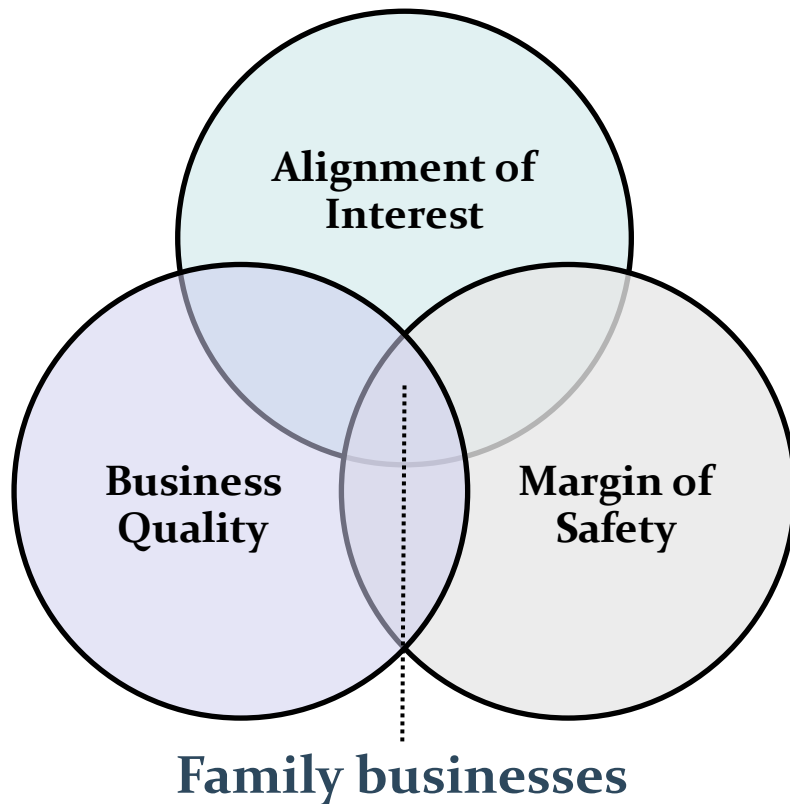
Family business?	Survival oriented (%)	Growth oriented (%)	Control Oriented (%)
Yes	77.5	64.6	69.0
No	22.5	35.4	31.8

*Study conducted on 922 UK businesses by Manchester Science Enterprise Centre, 2003

- Company is run by the founder and/or founder's family
- Majority of the family's wealth is in shares of the company
- Family's name and reputation are tied to the business

Alignment of Interests

Family businesses

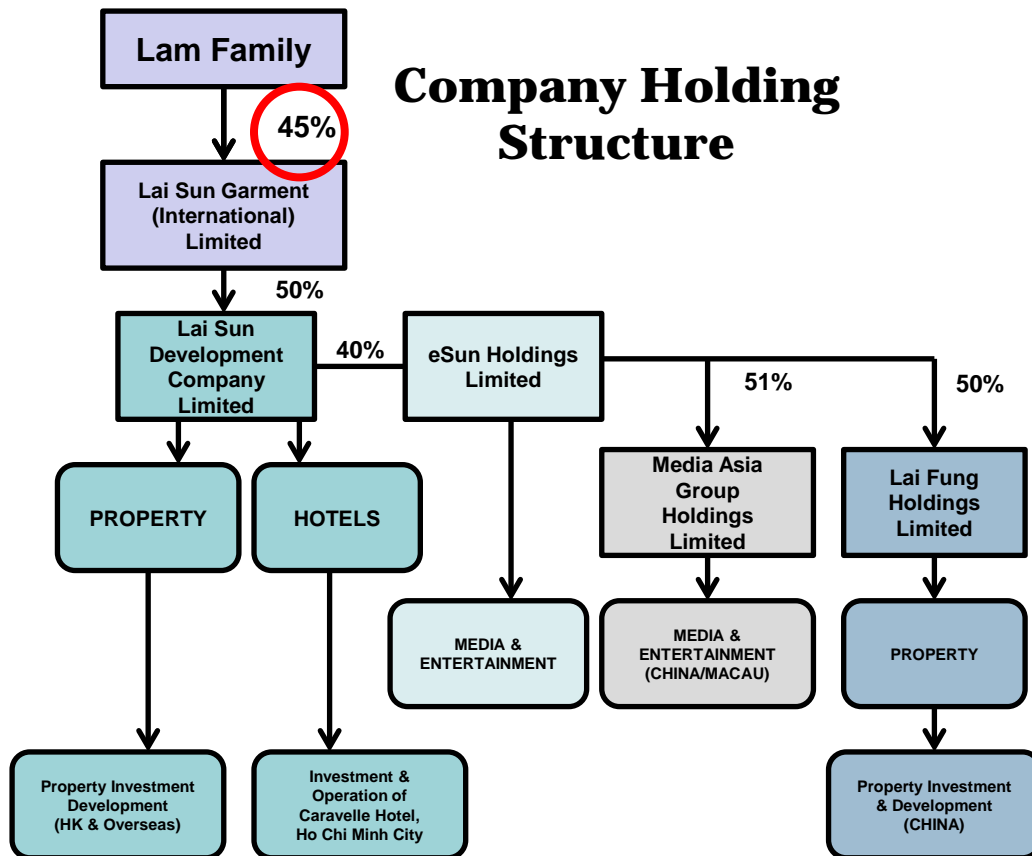


- As owners, the family benefits when other shareholders benefit
- Managers think like owners, not employees
- More “skin in the game”

Alignment of Interests

Case Study: Lai Sun Garment (191 HK)

Company Holding Structure



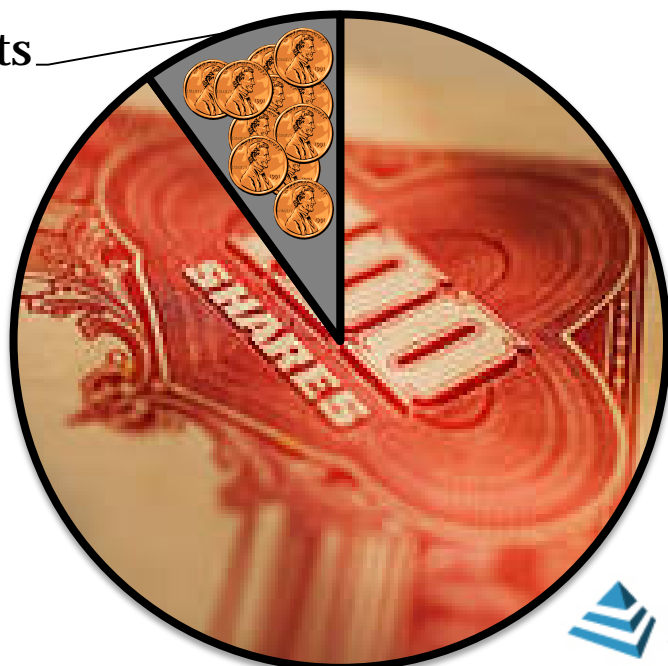
- Invest close to the owner's pocketbook
- Minority shareholders share in any pain as well as gain

Alignment of Interests

Case Study: Himax (HIMX US)

Wu Brother's Source of Net Worth

Other
Interests
10%



Himax
stake
90%



- Wu brothers collectively own 27% of the company's shares
- The stake represents nearly their entire net worth

Source: Dalton estimates, Bloomberg

Alignment of Interests

Mr. Dividend

“All my friends ask me, ' Am I number one in the world in [receiving] dividend payments?’” Lee tells Forbes during a recent interview in his splendid headquarters high above Hong Kong’s central office district. “I say, ' I don’t know, ask Forbes.’”

-- Lee Shau Kee, 1998
Founder of Henderson Land

He purportedly received US\$190 million in dividends,
tax-free

Alignment of Interests

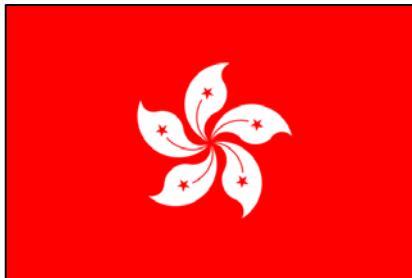
Tycoons bank on dividends

Founder	Company	Salary (2012)	Dividends received (2012)
Chung Wai Ping	Tao Heung	US\$28,000	US\$6.7 million
David Chiu	Far East Consortium	US\$350,000	US\$6.2 million
Li Ka-Shing	Cheung Kong	US\$1,200	US\$422.8 million

Source: Capital IQ, Bloomberg

Dividends vs. Salary Hong Kong

Region	Flat Income Tax	Dividend Tax	Capital Gains Tax
Hong Kong	15%*	0%	0%



- Income taxes, while low, are much higher than dividend taxes
- Executives minimize taxes by paying higher dividends in lieu of higher salary
- Shareholders benefit from higher dividends

*Residents have an alternative option of choosing a progressive tax with rates up to 17%

Source: Deloitte, 2013

Alignment of Interests

Dividends vs. Salary Singapore

Region	Top Income Tax	Dividend Tax	Capital Gains Tax
Singapore	20%	0%	0%



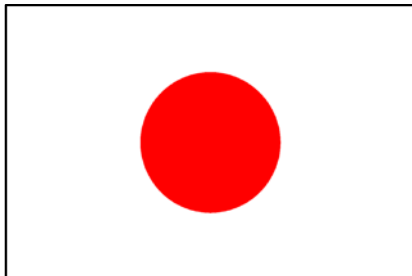
- Residents are taxed at progressive rates up to 20% on income
- Singapore residents also benefit from zero dividend taxes
- Incentivizes owners to pay high dividends over high salaries

Source: Deloitte, 2013

Alignment of Interests

Dividends vs. Salary Japan

Region	Top Income Tax	Dividend Tax	Capital Gains Tax
Japan	52.1%*	20%	20%



- Japan historically has concentrated compensation in base salaries
- Japanese firms hold large amounts of cash
- In recent years, dividend payouts have been on the rise

*40% national tax + 10% local tax + 2.1% surtax starting in 2013
Source: Deloitte, 2013

Alignment of Interests

Dividends vs. Salary Russia

Region	Flat Income Tax	Dividend Tax	Capital Gains Tax
Russia	13%	0-9%*	0%



- Dividends are taxed at 9% for individual residents
- Income tax comparatively higher at 13%
- Incentive is to pay higher dividends versus higher salary

*Legal entities that own over 50% of a subsidiary are entitled to receive dividends tax-free
Source: Ernst & Young, Deloitte, 2013

Alignment of Interests

Dividends vs. Salary India

Region	Top Income Tax	Dividend Tax	Capital Gains Tax
India	30%	0%	0%*



- The top marginal tax rate in India for individuals is 30%
- Individuals do not pay taxes on the dividends they receive
- Entrepreneurs pay lower taxes via dividend distributions than via salary.

*Exempt if held longer than one year; otherwise taxed at 15%
Source: Deloitte, 2013