JN Asia Infrastructure Fund SP

Newsletter QE 28th February 2018

Dear Investor,

This is the quarterly newsletter of JN Asia Infrastructure Fund SP ("the Fund" or "JNAIF") for the quarter ending 28th February 2018. The Fund currently manages total assets of USD8.1 million as at quarter end. For the quarter end, the Fund has delivered positive returns of 3.01% gross of fees and 2.71% net of fees.

What is your approach to investing in Asia Infrastructure?

For JN Asia Infrastructure Fund, we focus on a total return approach which places an emphasis on both long-term capital appreciation and dividend yield. We aim to construct a portfolio balanced between growth companies and those which offer a stable dividend stream. Industrials/ infrastructure companies tend to be a good source of growth particularly in a period of improving global economic outlook while utility businesses can provide stable high yield opportunities. Of our target 10-12% annualised return, 3-4% return should come from dividends and the balance from capital appreciation. We expect a large part of capital appreciation to come from earnings growth (6-12% p.a.) without assuming any substantial re-rating of the underlying valuation.

We combine a top-down and bottom-up approach to investing. With some broad understanding of the big picture, macro head/tail winds and secular trends in Asia, we use fundamental bottom-up approach to assess company's asset quality, pricing power, sustainability of cash flows and balance sheet management. Our investment style is quality growth at a reasonable price. We define quality companies as those which can sustain or improve margins; have positive operating cash flows in the past 3 years and are achieving an improving ROE or CFROI trend.

While we use MSCI Asia-Pac (ex-Japan) index and MSCI Asia Infrastructure index as reference points, given the infrastructure focus, the portfolio construction is unconstrained by these reference indices. Thus, the tracking error tends to be higher while beta and volatility of the portfolio should be lower than the reference indices.

What is the Infrastructure universe?

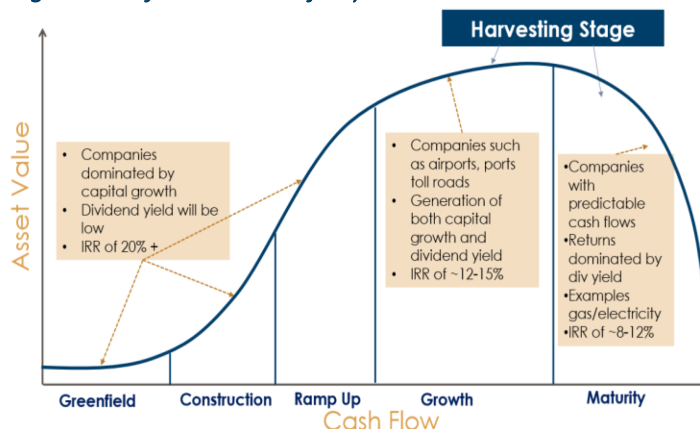
We divide infrastructure companies into two buckets, 'asset owners' and 'asset builders'. Asset owners are infrastructure companies which own their assets and generally provide services that benefit the economy. Examples include mid-stream energy assets, transport infrastructure, telecom towers and utility companies. In contrast, asset builders are those that are involved in the process of construction assets, such as companies in engineering and construction, capital goods and commodity resources related sectors.

Which part of the infrastructure life cycle do you invest in?

We own companies across the infrastructure life cycle in stages like greenfield (new projects), construction, ramping up, growth and mature stages. That said, we tend to focus on companies that offer solid dividend yield concentrated in growth segment (transport infrastructure, energy assets, etc) and mature segment (water and power transmission, etc). At present more than 90% of fund in these two segments i.e. 'growth' and 'mature', with an average dividend yield of 3.5%.

ARIANA INVESTMENT MANAGEMENT

Figure 1 - Infrastructure Life Cycle



Why are dividends important for the infrastructure names? Are they still relevant in the face of rising interest rates?

In past 12 months we have seen improving outlook for Global economy along with higher inflation and interest rates. However, given very high debt/GDP ratio for most of the larger economies and ageing demographics, the long-term growth outlook for nominal GDP as well that for inflation and interest rates are likely to be much lower than historical averages. In that environment, identifying companies or assets with sustainable pricing power (not driven by temporary government measures like currently seen in China), which translates into strong cash flows and high dividend yields is particularly important to provide a consistent source of income for the fund.

What kind of valuation metrics do you look at?

While we look at traditional valuation metrics such as price to earnings, price to book and EV/EBITDA. However, in the infrastructure space, other metrics are necessary to value companies. We focus a lot on Price to Cash flow metrics while the discount cash flow method is used to determine the upside potential. We also use Price to RAB (regulated asset base) to value regulated companies. As we look to balance growth with dividend stability, we also use DDM (dividend discount model) for mature companies.

Do you see valuation disparity between public and private markets for Infrastructure?

The valuation disparity between private and public space within Infrastructure remains large with public markets continue to trade at a discount particularly with recent fear of higher real interest costs. The M&A deals in private space remain active as reflected in Singapore Sovereign funds buying the US Student accommodation, Canadian Pension fund buying India's logistics assets, Hillhouse Capital buying China's largest logistics assets, Cheung Kong group buying Gas pipeline companies in Australia and recently Macquarie buying toll road assets in India. There are multiple deals in solar/ renewable space e.g. Global Infra Partners buying Equis Energy. Most of the transactions in private space are taking place at substantial premium to listed equities – partly driven by access to cash flows and partly to avoid public market volatility.

How is the infrastructure related capex and reform in Asia progressing?

The political leadership in countries like China, India, Indonesia, Malaysia and Philippines made strong commitments to infrastructure reform. Most of the Asian countries infrastructure spending has been a fulcrum of their fiscal stimulus to drive higher GDP growth as well as improving economic efficiency. Progress so far has been mixed.

In China, the reform has made reasonable progress as pricing power continues to shift from suppliers to customers viz. the gas transmission and distribution sector. There is also greater flexibility and transparency for transport related fees particularly in the airport sector. Infrastructure capex remains the main

growth component of China's fixed asset investment.

Turning to India, the investment climate improved somewhat after a new government came into power in 2014. Improvements in the project approval process and a decline in interest rates led to a better investment climate. However, a weak economy prevented a full-fledged capex revival. Meanwhile, the government took up the onus of reviving the economy through higher fiscal support to government dominated infrastructure sectors like railways, roads, metros, transmission, renewable energy. Most of the infrastructure builders have seen healthy improvements in order book as well as pace of execution in recent quarters.

Indonesia and Philippine are countries in great need of infrastructure development, for which their new leaders have started a capex programme in the right earnest. As large archipelagos, both Indonesia and the Philippines need significant investment in areas of logistics, power and urban transportation. In both countries, logistics costs as a percentage of GDP are significantly higher than that in Vietnam or Malaysia. It's quite clear that greater development in the areas of transportation and telecom will help to reduce these overhead costs. While Infrastructure capex under President Jokowi's leadership has moved up to 3% of Indonesian GDP, in the Philippines, President Duterte is targeting 6.5% of GDP in 2018.

However, the pricing reform in both these countries has been quite slow. Indonesia has recently come out with pricing policy for gas pipelines after a 3-year delay while the Philippines is yet to sort out the regulatory mess in water, power and toll road sectors. Lack of progress in pricing reform may delay participation of private companies in the infrastructure sector. For India, though some progress has been made in the gas transmission and oil marketing segment, the occasional regulatory mishaps continue to create investment uncertainty for private participants.

In which part of the region you see maximum opportunities?

Given our bottom-up approach, we try to avoid taking a very firm view about any country or market. However, given rising expectation about higher inflation and rates driven by synchronised global recovery, many long-dated assets including some quality REITs are trading at attractive valuations – based on both cash flow metrics as well as dividend yield. That puts markets like Australia, Singapore and New Zealand on our investment map. Some of the high-quality telecom tower assets in AESAN and gas utilities in China are currently at attractive valuations. As a country, India seems to be carrying high risk given strong macro-headwinds and lofty valuations.

Our portfolio currently has an eclectic mix of assets - toll roads and gas utilities in China, telecom tower and pipeline in Indonesia, waste management and LNG assets in Australia, retirement house, hydro power in New Zealand, student & foreign workers accommodation in Singapore, airport, port in Malaysia and energy asset in Philippines. Dividend yield ranges from 1.5% to 7%, growing between 5% to 20% annually.

In a rising interest rate environment, how have you positioned the fund to benefit?

As Asia continues to develop, there is a need for far more infrastructure spending. Accommodative monetary policy in the region particularly in absence of any sharp inflation pressure, should lead to greater infrastructure investment, whether driven by public institutions or private companies. In addition to that China's Belt-Road initiative

(BRI) will drive significant infrastructure investments in ASEAN countries.

We choose to position the portfolio in quality companies, with strong visible, sustainable cash flows and rising dividend yield. Nonetheless, some of these companies with long dated assets will face headwinds from higher real interest rates, which mostly affect their cost of capital assumptions. To minimise this adverse impact, we focus on a few medium-term drivers, which eventually will keep us in good stead.

a) ability of the companies/ assets to price their products or services in line with rising inflation, which in turn protects their top line and profitability,
b) businesses which are enjoying volume tailwind from global recovery e.g. energy assets, airports or ports etc.
c) companies with strong balance sheet, credit rating and ability to keep overall interest cost at lower level
d) we consider 10 years rolling average cost of debt (instead of spot rate) while calculating cost of capital to arrive at the valuation.

While we don't take a specific view on interest rate or inflation, two key drivers of inflation are worth watching. Wage inflation, which seems to be on a rising trend and the global capex cycle which is less likely to see big upsurge since China's capex cycle has more than likely peaked in late 2017. China represents more than 50% of global incremental capex. Out of 3 components, while manufacturing and infrastructure FAI growth is likely to be subdued, the real estate capex in China could be limited to tier-3 and 4 cities. Even the global capex cycle, despite recovering from trough of 2015-16, is still very subdued particularly in the commodity sector. Chinese PPI, a leading indicator for Global inflation, has peaked out in late 2017.

Lastly, the Chinese economy which contributed more than 50% of incremental global nominal GDP growth since GFC, is showing signs of a slowdown driven by both fiscal and monetary tightening. Even Europe's economic data have stopped showing positive surprise – probably due to a strong currency.

How do you manage multiple currency exposures?

As a matter of investment process, we don't take an explicit currency view. However, we acknowledge extreme currency movements in some occasions viz. one in January 2018. We try to manage our purchase or sale activity around such extreme movements. We also limit total exposure to a geography which has volatile currency. Lastly, in a geography with weak currency, we try to hold assets which have some offsetting mechanism in terms of higher revenues and earnings.

Table 1 –Portfolio Top 5 Country Allocation

Top 5 Country Allocation	Portfolio %
Australia	21.6%
China	14.2%
Singapore	11.9%
New Zealand	9.8%
Indonesia	9.7%

Table 2 - Portfolio Top 5 Company Allocation

Top 5 Company Holdings	Portfolio %
Macquarie Atlas Roads Group	4.8%
Mapletree Industrial Trust	4.5%
Sydney Airport	4.3%
APA Group	4.3%
Bingo Industries Limited	4.2%