JN Asia Infrastructure Fund SP

Newsletter QE 31st August 2018

Dear Investor,

This is the quarterly newsletter of JN Asia Infrastructure Fund SP ("the Fund" or "JNAIF") for the quarter ending 31st August 2018.

The Fund currently manages total assets of **USD 9.4mn** as at the quarter end.

For the quarter, the Fund has delivered ***positive*** returns of **2.34% gross of fees** and **1.94% net of fees**. In this period, the reference benchmark (MSCI Asia-Pac ex-Japan) posted a ***negative* 4.88% return**.

The August quarter saw its fair share of market gyrations across asset classes in the backdrop of a deepening trade war and a sharp oil uptick. This is elevating the pain levels for several nations, particularly for Emerging Markets. Hence, as we enter this new quarter, we think that it is apt to discuss the key issues arising from the above context and throw some light on our portfolio approach in this newsletter. Alongside our views on China, we also discuss our views on some of the subsectors like Airports, Emerging Infrastructure Assets and the incremental risk arising out of higher Oil Prices.

Did the China's slowdown come to you as a surprise?

In our last Quarterly newsletter in June 2018, we explained our large underweight position in China and foresaw an impending slowdown in Chinese economy. This was driven by the government's de-leveraging agenda and decline in Infrastructure fixed asset investment (FAI). However, the ongoing trade war with the US accelerated this process and we saw market dislocation in June-2018 and subsequent change in government's policy stance.

We believe that the current slowdown in Chinese economy would have continued with / without the trade war. In the initial stage, this (evolving) trade war has driven negative sentiments and has impacted SME export orders. A weaker CNY has reduced this impact to an extent. However, we think that FAI driven slowdown deriving out of tightening PPP projects and lower fiscal stimulus in tier-3 cities is more structural in nature, and unless the govt. makes a complete U-turn on its deleveraging agenda, the economic slowdown should continue, though at a slower pace.
We believe that a full-fledged monetary or fiscal stimulus should be perceived negatively by the market for structural reason. However, in near term, a gradual monetary easing and proactive fiscal policy will lead to a market revival, particularly when lending data starts improving in coming months.

What do you think of renewed monetary and fiscal easing in China and will that change your underweight position in China?

We believe the renewed monetary and fiscal easing in China raises a few questions: a) The country's sustainable GDP growth is probably much lower than current reported 6-6.5% - may be closer to 4-4.5%. Since GFC, the country had to resort to this kind of easing programme fourth time (other three in 2009, 2013, 2016). Every time as the impulse from stimulus goes down, GDP growth (particularly, *nominal GDP growth)* starts floundering. Also, every incremental stimulus reduces ICOR for the country and capital productivity while piling up additional debt; b) Secondly, this puts question on the govt.'s deleveraging agenda, which started in mid-2017 as the economy was on a recovery path. This also reflects that supply side reform provided a monetary boost to pricing power for the old industries. In fact, recent relaxation of risk weight for LGFV loans is a volte-face for the govt. who was looking to limit banks' exposure to this segment; c) Lastly, contrary to general perception of modest contribution of net exports to GDP, the impact of gross trade (i.e. exports + imports), probably represent 30-40%

ARIANA INVESTMENT MANAGEMENT

of China's GDP and thus makes it vulnerable to ongoing trade friction with the US.

We don't see any reason to reduce our underweight position in China. The investment community continue to stay constructive on China's outlook unlike early 2016, when fear of a hard landing was very high. Investors still think that supply side reform is a massive success, while in reality, China's production in each of those sectors (Steel, Aluminium, Cement, and probably Coal) are higher than what was three years back. Unlike 2016, we believe this time fiscal and monetary easing will be calibrated. Given sharp rebound in real estate prices in tier-1 & tier-3 cities, there is a limited scope to stimulate this sector. On contrary, the current PSL-Pledged Supplementary Lending, programme in tier-3 cities (akin to China's QE programme) is unlikely to continue for long given the sharp rise in real estate prices in tier-3 cities. Lastly, there is a limitation on how much infrastructure capex can be revived since already Infrastructure build up (in terms GFA per capita) is quite high, and most of the PPP programme for Infrastructure will lead to further rise in local government's debt.

What do you make out of MIC 2025 and any infrastructure exposure you have currently, which can benefit from MIC 2025?

We believe Make in China (MIC) 2025 could turn out to be a large misallocation of resources while making excess capacities in multiple industries and across its value chain. However, we don't see any direct impact on infrastructure sector or the names we currently have in China. Given the scale of investment in MIC 2025, which is RMB 4tn (comparable to fiscal stimulus in 2009), we believe it will create massive over capacity in sectors like, Electric Vehicles, Batteries, Automation and so on. This reminds us of massive capacities China created in renewable energy to reduce carbon footprint and improve energy mix. That had diminished return and profitability in sectors like Wind, Solar, Waste management or even Railway equipment. We wouldn't be surprised if there is a similar outcome this time in sectors like Electric Vehicle, Batteries or Automation.

How is your portfolio positioned in a secular trend like Chinese outbound tourism?

We believe Chinese outbound tourism is a secular trend and should continue to grow higher than Global outbound growth. Based on various estimates, we expect that the outbound traffic from China will continue to grow at 8-10% p.a. for the next 5 years and 6-7% in the long term. This will be driven by rising disposable income of Chinese middle class. Even though occasional Renminbi depreciation may dampen this discretionary spending, the long-term trend is unlikely to get impacted. This is reflected in rising leakage in China's current account. It's estimated that 60-70% of outflow in current account is related to outbound travel, spending.

While the above trend is fairly consensus, we intend to capture the upside from it in a slightly different set of equity picks vis-à-vis the more consensus ones. To put this approach in context, while we do agree that investments into online travel space, through the likes of C-Trip, Chinese Airlines or Hotel names in China typically capture the above trend quite well. However, in our opinion, none of the above businesses have 'moat' kind of characteristics, implying that stiff competition (both domestic and overseas) will more than often partially or fully offset the pricing power of these players, thereby impact returns. In fact, we would point out that even companies like China's *TravelSky Technology*, which has a monopoly position in ticket bookings for Chinese Airlines, hardly has any pricing power vs. its parent entities, i.e., the Chinese Airlines.

In light of this, we believe that Infrastructure Assets like Airports at both originating and destination countries are a much better investment proxy to this secular theme. While at one extreme, *Airport of Thailand* has one-third of its pax traffic exposed to Chinese tourists, for the other Airports like *Sydney* and *Auckland*, Chinese travellers represent 15-20% of traffic (a higher portion of non-Aero revenues), a substantial number to play the upside, though at the same time, does not expose us to untoward stock gyrations. In addition to that, given Chinese travellers spend 2-3x more than an average passenger, the Airports also benefit disproportionately through uplift in retail sales.

We also like *Chinese Airports* as the regulatory regime is relatively more benign. Even though the landing charges and passenger service charges are capped, the dual-till model gives incentives to the airports to earn from higher retail sales and advertisement. The recent re-contracting of duty-free shops in some of the hub-airports have gone well in favour of Airports with 35-45% revenue sharing arrangement. Additionally, there is the possibility of increase in landing charges for foreign airlines, which have been constant for past many years. In conclusion, we believe that the regional airports are a much superior way to play the Chinese outbound secular theme due to their pricing power, limited competition, long term predictable cash flows, and substantially lower risks.

How do you read the recent bid by Cheung Kong group's bid for APA assets and valuation gap between Private and Listed Infra assets?

For quite some time we have argued that the listed Infrastructure market provides an attractive opportunity in Asia-Pac space for investors who can stomach some bout of volatility. Their valuation continues to trade at discount to unlisted peer-group. This gets tested every time when a listed asset attracts a privatisation bid.

In this case, *APA*, which is Australia's largest gas transmission company, attracted a bid from *Cheung Kong Infrastructure group* (an Infra conglomerate), where the bid price was 31% premium to the then prevailing trading price. Besides controlling premium, the bid price reflects attractiveness of core-Infra assets and long term predicable cash flows it can generate with minimum volatility.

We believe that on an average one or two names of our 25-stock portfolio will attract such M&A bids per year, which should provide an additional alpha to our investors.

Why does your portfolio have a large underweight position in Power producers?

Even though the Power sector represents the largest weight in any infrastructure universe, this sector also carries the maximum amount of regulatory and market risks as well. For Independent Power producers (IPPs), the assets are subject to market volatility of power prices as well as short duration contract, both of which fail to deliver a long term consistent Infrastructure kind of return. In addition to that, the emerging markets in Asia are also subject to political and regulatory interferences viz. India, China, Korea, Indonesia, Malaysia, etc.

For the power producers which are regulated, in most of the cases the counterparties are State distribution companies, which are always under financial stress as they work under populist pressure viz. India, Indonesia.

Thus, as a fund manager for an Asia-Pac fund, we have restricted our exposure to only transmission entities within the Power space, which are mostly regulated and see less interference from the government. The returns for this asset are predictable and have long term visibility.

Additionally, we have also restricted our exposure to Developed markets, where regulatory regimes tend to be both consistent over long-term, and stable, alongside well established institutional frameworks subject to limited political interference.

How do you see building up exposure in new/ emerging Infrastructure asset class?

Of late, we have seen Infrastructure Managers building up exposure in emerging Infrastructure assets (also termed as "Core Plus") viz. Data Centres, Energy Storage, Student Accommodation. While we do believe that this emerging asset class enjoys Infrastructure kind of properties and returns, we are quite cognizant to certain additional risk factors, for instance, technology obsolesces and higher maintenance capex for Data Centres and Energy Storage businesses. On the other hand, Student Accommodation are NOT natural monopoly assets and are generally run by third parties.

Keeping this in mind, we have taken a selective exposure to Student Accommodation. In this case, the company runs an entire value chain from sourcing students, managing the accommodations, and is often involved in Asset enhancement exercise. In our assessment, its assets are located in prime education centres, which enjoy high occupancy rates and CPI linked pricing power. We also have an indirect exposure to a Data Centre business through one of our Industrial Infrastructure company. Around 20% of its NAV is derived from Data Centres located in developed markets.

India continues to surprise investors by being the best performing market. What's the current investment outlook for Indian market?

As JN Asia Infra Fund is getting closer to requisite approval for investment in India, the fund will take a cautious approach towards Indian market. The reasons being as follows:

a) The robust earnings growth in Q1FY19 partly derives from prior year's lower base due to GST related slowdown, weak rupee benefiting export sectors like IT, Pharma and commodities which are priced on landed cost basis. The earnings growth will face higher base in coming quarters, while some of the commodity prices have corrected since then.
b) This is the first time under the current govt. that the economic growth has seen a genuine pick up across sectors like construction, consumption, real estate, higher credit pick-up etc. However, this is also being accompanied by a widening trade gap (rising imports outpacing modest exports growth). We don't see situation to be sustainable as the govt. fiscal stimulus may wind down as we come closer to mid-2019 elections. Similarly, measures may be needed to curb import demand to prevent accelerated weakening of rupee, something we saw in 2011.
c) Inflation may surprise on the higher side, due to a weakening rupee and higher oil prices. We believe that the country has frittered away all the gains it made during lower oil price regime with little policy initiatives to improve domestic production. As described later, in not an unlikely scenario of US$90-100/bbl oil price, the country may have to pay dearly for its lack of initiatives in hydrocarbon sector when oil price was low.

Lastly, the market valuation is stretched, and its valuation premium (to EMs and Asian markets) is as high as seen in early 2008. Even after a strong earnings quarter in Q1FY19, we have seen an across the board earnings cut. In summary, we may stay underweight in Indian market for now, and like China, will intend to take a barbell approach given that the rupee is still in a vulnerable position and rate increases may surprise on the higher side to arrest the currency fall.

According to you what's the key risk for the market and your portfolio?

We believe that at present the most tangible risk factors are Fed tightening along with a strong USD, and trade frictions mainly between the US and other countries. However, we believe that another risk factor is lurking in the horizon, i.e. oil price. It seems to us that a US$90-100/bbl oil price is not an unrealistic scenario in the coming months.

This comes from three factors – near term as well as medium term. In near term, the implementation of full-fledged economic sanctions on Iran can take out another 1-1.2mn bbl p/d of capacity from Global market when inventory level has already come down below 5 years' average. The medium-term factors are – continuous upsurge in oil demand and falling hydrocarbon capex. Despite many pundits' claim about peaking oil demand in 2021/22 and hydrocarbon being a sunset industry, the ground reality is turning out to be quite different. Last three years turned out to be one of the best period for oil demand in past two decades with average annual oil demand of 1.6-1.7mn bpd. This demand is coming from transportation sector (more SUVs, and personal vehicles in emerging countries, air travel), industrial activity (Petrochemical etc.)

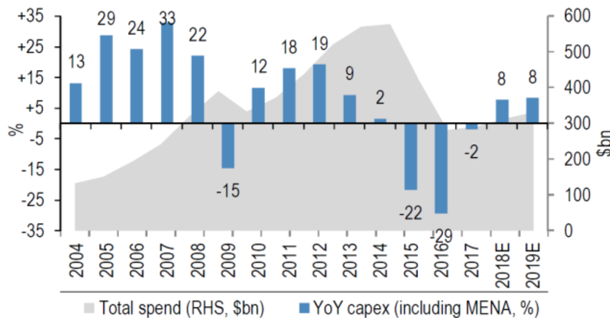
Lastly, the over enthusiasm about Electric Vehicle industry and over optimistic outlook on the US Shale oil industry has led to 60% drop in Exploration & Development capex in hydrocarbon sector. Even after oil price recovering from low $30/bbl level to current $80/bbl, E&P capex has picked up only by modest 8-10% from bottom. On the other hand, despite oil price hovering well above the breakeven price of US Shale producers ($45-50/bbl), the output has apparently plateaued thanks to rising production costs, falling productivity of oil rigs, and constraints in evacuation infrastructure. Paradoxically, over-enthusiasm about Electric Vehicle industry is doing a bit of disservice to oil consumers as it is limiting any large-scale investments in new hydrocarbon reserve or deep oil exploration. We believe that the world is quite ill-prepared for an oil shock and the event of oil price sustaining over US$100/bbl.

Our relatively bullish stance on hydrocarbon prices is reflected in our overweight position in energy infrastructure companies and LNG value chain as well as gas utilities who should benefit from higher oil prices leading to higher demand for substitute cleaner fuel like gas.

JN Asia Infrastructure Fund SP

Newsletter QE 31st August 2018

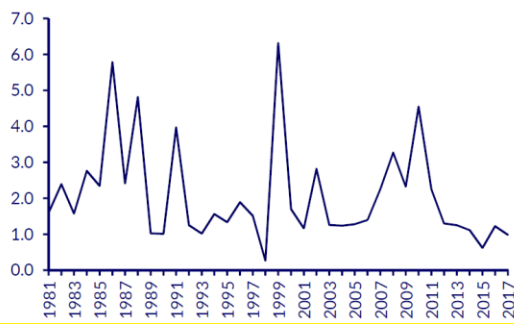
Upstream Capex ($bn, RHA) & YoY Growth (%, LHA) Since 2004



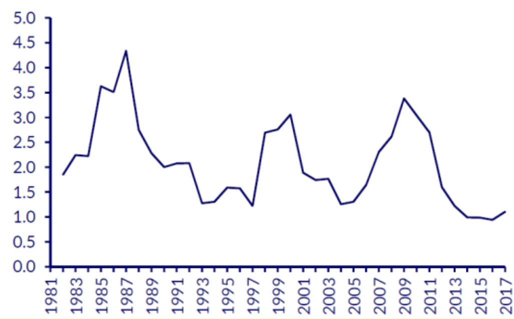
Source: Company Reports, J.P. Morgan Estimates

Global Reserve Production Ratio (X)

Global oil reserve replacement ratio (RRR) - annual



Global oil reserve replacement ratio (RRR) - three-year rolling



Source: CLSA, BP Petroleum Statistics

Table 1 –Portfolio Top 5 Country Allocation

Top 5 Country Allocation	Portfolio %
Australia	20.7%
China	14.5%
Singapore	12.6%
Philippines	9.7%
Hong Kong	8.8%

Table 2 - Portfolio Top 5 Company Allocation

Top 5 Company Holdings	Portfolio %
Bingo Industries Ltd	6.3%
Jiangsu Express Co Ltd (H)	5.7%
Kerry Logistics Network Ltd	5.0%
APA Group	4.9%
Mapletree Industrial Trust	4.6%

Disclosures

The information and statistical data contained herein have been obtained from sources, which we believe to be reliable, but in no way are warranted by us to accuracy or completeness. We do not undertake to advise you as to any change in figures or our views.

This is not a solicitation of any order to buy or sell. We, any officer, or any member of their families, may have a position in and may from time to time purchase or sell any of the above mentioned or related securities. Past results are no guarantee of future results.

This report includes candid statements and observations regarding investment strategies, individual securities, and economic and market conditions; however, there is no guarantee that these statements, opinions or forecasts will prove to be correct. These comments may also include the expression of opinions that are speculative in nature and should not be relied on as statements of fact.

JN Asia Infrastructure Fund is committed to communicating with our investors as candidly as possible because we believe our investors benefit from understanding our investment philosophy, investment process, security selection methodology and investor temperament. Our views and opinions include "forward-looking statements" which may or may not be accurate over the long term. You should not place undue reliance on forward-looking statements, which are current as of the date of this report. We disclaim any obligation to update or alter any forward-looking statements, whether as a result of new information, future events or otherwise. While we believe we have a reasonable basis for our appraisals and we have confidence in our opinions, actual results may differ materially from those we anticipate. The information provided in this material should not be considered a recommendation to buy, sell or hold any particular securities

ARIANA
INVESTMENT MANAGEMENT