JN Asia Infrastructure Fund SP

Newsletter QE 30th November 2018

Dear Investor,

This is the quarterly newsletter of JN Asia Infrastructure Fund SP ("the Fund" or "JNAIF") for the quarter ending 30th November 2018.

The Fund currently manages total assets of **USD9.1mn** as at the quarter end.

For the quarter, the Fund has delivered ***negative*** returns of **3.86% gross of fees** and **4.22% net of fees**. In this period, the reference benchmark (MSCI Asia-Pac ex-Japan) posted a ***negative* 8.02% return**.

The November quarter saw weakness spread across markets as the US-China trade tension worsened, crude oil prices fell sharply, while Fed hawkishness, technology sector pullback and board macro worries took centre stage. As valuations came down, we take stock of the situation, and discuss both broader economic issues as well as specific investment themes in this newsletter. We discuss our view of the Global growth in 2019 and its key drivers, outlook on inflation, rates, and their impact on long dated assets like Infrastructure. We also discuss China's slow down amid the trade issues, impacts from the sharp Oil moves on Chinese Gas sector, and Indian market.

As we approach the end of 2018, what is your outlook for Global Growth and hence portfolio positioning for 2019?

In our Feb'18 newsletter, we were sceptical about absence of a synchronized global recovery (a market consensus at that point of time) and foresaw a slowdown in economic growths in Europe and China. This has played out in 2018. In 2019, we may see a stabilisation of growth in China at a lower level and a likely slowdown in the US economy. We agree with the consensus view that the absence of tax stimulus and the one-time repatriation of overseas cash pile will reduce tailwinds for the US economy, which is already in late cycle of growth. Also, Japan is already showing sign of fragility and expected increase in sales tax in 2019 may dampen the growth further. Lastly, we don't see any specific reasons leading to the revival of sagging growth in the Euro area, besides weak currency.

We are also not that sanguine on inflation outlook. We dwelled on this topic in early 2018 and continue to believe that the absence of large scale capex recovery globally will keep one key leg of inflation weak. Even though China is likely to see an improvement in Infrastructure capex going forward, overall fiscal stimulus is likely to be limited given its high debt levels. On the other hand, China's real estate investments may continue to slowdown from the current levels. Lastly, Oil & Gas capex was one of the key reasons for the recent uptick in US corporate capex. However, a collapse in oil price may stall this capex revival as well – something we saw happen in 2015. The other driver, i.e. sustained wage recovery, is not showing real signs outside the US.

How does the above view of Global Growth outlook and inflation translate into interest rates and corporate earnings growth?

Given this outlook, we think that the interest rate cycle is peaking, a view contrary to market expectations even a few weeks ago. In that case, sustained rate hikes by Fed may increase real cost of capital, which will prove to be a headwind for equities. On top of that, the expectations of earnings growth for 2019 are still quite high. While analysts have cut earnings for 2018 in the past few months, consensus still seems sanguine about earnings recovery particularly in the cyclical sectors (autos, commodities, industrials, technology) in 2019. In our opinion, this is where a big disappointment may come, even though equity valuations particularly in Asia have started reflecting that.

In our portfolio, we continue to focus on companies where we see: a) delivery of earnings on a sustained basis irrespective of

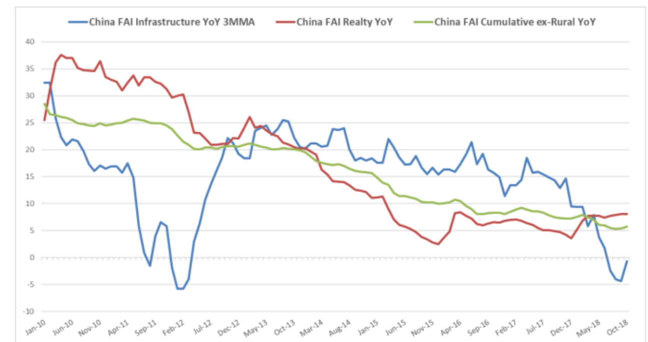
the economic cycle; b) idiosyncratic investment ideas, where earnings are likely to revive in 2019/20 after company/ industry level restructuring; c) operating cash yield of 8-10%, with high Free cash flow yield as well. The average earnings growth expectation for our portfolio remains a modest 6-8% with dividend yield of 3.5-4%.

Do you think the recent pause in trade war between the US and China may help economic and earnings recovery in China?

While the ongoing trade war between the two largest economies of the world has become a ***lightning rod*** for the market, we believe that China's economic slowdown and earnings deceleration is largely due to its own country specific reasons. While 'trade war' is being used as an excuse to cut earnings and multiples, by the brokers, we believe economic and earnings slowdown in 2018 is mainly due to government's de-leveraging agenda. This vulnerability can amplify This, in turn reflects how vulnerable the economy and more importantly the earnings are in the event of a potential slowdown in credit growth or disruption in shadow banking. Thus, we believe that last week's truce between the US and China on trade front may not have much impact on earnings recovery in 2019.

For right reasons, the Chinese government is not going for a blanket fiscal stimulus and is rather limiting its scope to urban infrastructure and some of the cross-country railway line projects. China's focus is more on helping consumers through tax cuts, which should help in medium to long term. Even though the current real estate tightening can be relaxed, this is less likely due to already poor affordability in tier 1 cities and large inventory build-ups in tier 2 and 3 cities.

In summary, we believe that the Chinese markets may not see a robust earnings recovery in 2019 particularly the sectors which depend on cyclical strengths of the economy.



Source: Bloomberg, National Bureau of Statistics (China)

As Oil prices stumbled by 30% in less than two months, what is the impact on your portfolio?

The recent precipitous fall in crude oil prices reflects the danger of taking explicit call on a specific commodity or a specific event like Iran sanctions and building a portfolio around that. In Aug'18, we wrote about the potential oil price spike resulting from upcoming Iran oil sanctions and impact on some of the Asian markets. The oil price indeed spiked in Sep'18 and that was followed by a sharp fall in Oct-Nov'18 period.

In terms of our portfolio, falling oil prices benefited it as follows: a) Asian importers like Indonesia, India and the Philippines saw sharp reduction in current account deficits leading to rebound in their currencies; b) reduced threat of higher LNG prices in China during the winter months (Asian LNG is linked to Brent oil prices); and c) some indirect benefit to oil marketing company that we are holding, through higher product demand and spreads.

Having said this, we remain constructive on oil prices in the medium term mainly due to robust global oil demand (in fact, 2019E oil demand at 1.6-1.7mn bpd should be better than 2018E demand of 1.5-1.6mn bpd), and lack of E&P investments with four consecutive years of falling 'Reserve/ Production 'ratio. (Ref. chart below; also refer to pages 5-6 of our Aug'18 newsletter)

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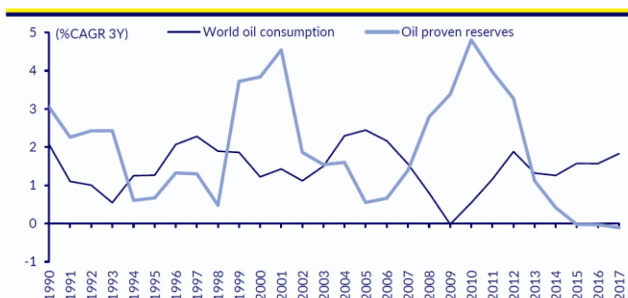
Our medium term bullish stance on oil prices is reflected in our overweight position in energy infrastructure companies, the LNG value chain, as well as gas utilities that should benefit from higher oil prices leading to higher demand for substitute cleaner fuel like gas.



Source: CLSA

What do you think of a potential margin squeeze in the coming winter for Chinese Gas distributors?

The Gas sector is one of the few secular investment stories in Chinese stock markets, one that continues to show a resilient earnings growth of 10-15% p.a. In a global backdrop where growth is likely to slow-down further in 2019, a defensive earnings growth of 10-15% should stand well. Of late, two primary concerns have led to de-rating of the sector: a) potential reduction in connection fees; and b) margins squeeze due to winter gas shortage – something we saw in 2017. Without getting into the merits of having connection fees and level of margins the gas operators should earn on it, we believe in a scenario where gas operators recover only their costs of providing the connection and their cost of servicing the said connection for next 30 years, there will be a one-time rebasing of earnings in 2019. Post that, earnings should revert to their 10-15% p.a. growth trend for next several years.

As discussed earlier in this note, the recent drop in oil prices has led to sequential decline in Asia's LNG prices in a period when seasonal demand peaks. In addition to that, the three Chinese oil companies and the downstream gas operators are much better prepared this year to meet the winter gas demand, meaning that the kind of shortage witnessed in 2017 should not recur. Overall, we see a mild impact on gas margins for the operators, and in some cases like ENN Energy, there may be a sequential improvement as well.

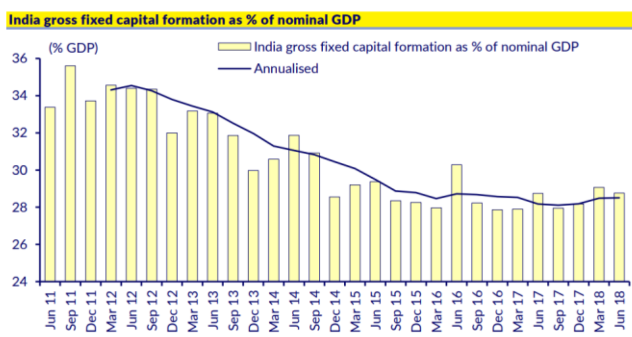
We do believe that the market is justifiably worried about demand slowdown in 2019, in line with slowdown in the broader economy. However, our 10-15% earnings growth for 2019 is based on a similar level of volume growth, which is much slower compared to the 20-25% volume growth in 2018. What stands out for the sector, though, is its sustainability of earnings and ability to generate strong operating as well as free cash flow. Most of the gas operators are trading at 8-12% operating cash yield with low leverage.

Despite recent drop in oil prices and reduction in government bond yields, why you are still not constructive on Indian market?

There are some short-term as well as some medium-term concerns on the Indian market, which are preventing us from getting constructive. The short-term issues are: a) the valuation premium of India market vs. Asia and EMs has moved back closer to historic high; b) earnings downgrade post-Q2FY19 results has accelerated; and c) a possible bounce back in crude oil prices (as discussed earlier).

In the medium term, other structural issues come to fore, viz: a) Widening fiscal deficit as GST collections continue to miss estimates. To bridge that, we sense desperation of the Indian government in taking measures like appropriation of Central Bank's excess reserves and selling PSU stocks at deep discounts. To us, this implies that the

government spending – both at the central level and at the state level – is likely to fall in 2019, thus accelerating economic slowdown. The positive impact of the 9th Pay Commission will also go away in the coming quarters; b) Political uncertainty will stay till the general election in 2019; c) The unprecedented liquidity unleashed by ill-conceived de-monetisation programme two years back has run in course. The liquidity deficit is now well reflected in the system, particularly for the NBFCs. A slowdown in NBFCs' lending (35-40% of incremental credit growth in past three years), could lead to a slowdown in overall credit growth. This in turn may impact consumption growth as well as nascent capex recovery including that in real estate.



Source: CLSA, CEIC Data, Ministry of Statistics (India)

In summary, we may stay underweight in the Indian market for now, and, may take a barbell approach given multiple uncertainties and structural headwinds, which the market may face in coming quarters.

Why are you so constructive on Waste management sector particularly in Australia?

We remain constructive in Waste management sector particularly in the developed markets, where there is durability of contracts and high focus on sustainable growth. In this context, we think that the Australian waste management sector has a long runway. Some of the tailwinds are –

A. Consolidation of the sector, particularly in view of some of the home-grown local operators that are exiting the sector, even though some of global leaders like Suez or Veolia are focusing on larger markets viz. Europe and the US. We see a good similarly between Australia Waste management sector with that in the US around 8-10 years back.

B. Margin Improvement– Consolidation, besides providing scale in turn driving operational efficiency, also provides better pricing outlook. Municipalities and big supermarkets are now consolidating bids and offering larger contracts, where operational scale matters.

C. Environment / Sustainability – Among developed countries, Australia's waste generation per capita is among the highest globally, and is growing at 1.2-1.3x of GDP growth. This gives a strong secular tailwind. In addition, focus on environment is leading to a greater thrust on recycling. A lesser number of sites are now available for dumping of unprocessed waste, thus, companies with strong recycling capabilities as well the ones with prime landfill sites are key beneficiaries. China's recent ban of import of plastic waste has further increased focus on recycling.

D. Lastly, some of the niche segments like hazardous waste and medical waste, are seeing consolidation and growth much faster than GDP growth rate.

Even though there is concern of housing sector slowdown, this sector represents less than 25% of Construction & Demolition market, which itself is about 30% of total waste management market. We continue to like the market leaders in each of these categories.

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What is your thought on valuation disparity to private Infrastructure asset class, particularly after the recent de-rating of listed universe?

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 a discount to the unlisted peer-group. The discount has widened in the recent past following the meltdown in equity markets, where Infrastructure equities saw a de-rating (though significantly less than broader equities). On the other hand, as more number of Global Pension Funds and Infrastructure Funds set up base in Asia, a larger quantum of capital will keep chasing a limited number of Core Infrastructure assets.

This gets tested every time when a listed asset attracts a privatisation bid or when unlisted Infrastructure assets go for listing. In this year, we have seen APA, which is Australia's largest gas transmission company, attract a bid from Cheung Kong Infrastructure group at 31% premium to the then prevailing trading price.

Compare this to cases such as some Indian renewable energy companies that are struggling to get listed even with a 20-30% discount to the valuation where Private Infrastructure Funds last invested into them.

Top 3 Country Allocations	Portfolio (%)
Australia	18.6%
China (HK)	17.8%
Singapore	14.4%

Top 3 Equity Holdings	Portfolio (%)
FREIGHTWAYS LTD	6.2%
Bingo Industries Limited	6.1%
SYDNEY AIRPORT	5.8%

Disclosures

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