JN Asia Infrastructure Fund SP

Newsletter QE 28th February 2019

Dear Investor,

This is the quarterly newsletter of JN Asia Infrastructure Fund ("the Fund" or "JNAIF") for the quarter ending 28th February 2019.

The Fund currently manages total assets of **USD9.8mn** as at the quarter end.

For the quarter, the Fund has delivered returns of **6.65% gross of fees** and **6.37% net of fees**. In this period, the reference benchmark (MSCI Asia-Pac ex-Japan) posted **8.42% return**. Since inception, JNAIF has delivered **9.28% (gross)** and **7.46% (net)**. On a relative context, this translates to cumulative outperformance of **17.3% (gross)** and **15.4% (net)** vs. MSCI Asia-Pac (ex-Japan).

The February quarter was a story of two stark opposites – it started with a doom & gloom scenario, and then metamorphosized into an exuberant one as 2019 began. The US Fed's policy U-turn, coupled with China's new round of stimulus, not to mention the rising possibility of a trade truce between the two countries led to a significant soothing of market nerves. While market action has largely been positive this year, we stay selective in stocks and markets as economic issues from over-leveraging, low growth & deflation are much more structural. Our discussion ahead seeks to give further details into our thought process at this point.

How is the portfolio positioned if the current business cycle, which started from 2009, matures and ends?

In our Feb'18 newsletter, we were sceptical about a synchronized global recovery (a market consensus at that point of time) and foresaw a slowdown in economic growths in Europe and China. This played out well in 2018. Going forward, we may see a stabilisation of growth in China in second half of 2019 at a lower level and a likely slowdown in the US economy. We remain worried about duration and strength of the current business cycle. As we write, some of the major economies like Japan and Europe have gone into sub-par growth trajectory even before the respective Central banks start unwinding their balance sheets. We also agree with the consensus view that the absence of tax stimulus will reduce tailwinds for the US economy, which is already in the late cycle of growth.

However, we are more worried with the fact that the current business cycle is now 10 years old and showing signs of maturity even when the leverage level is at an unprecedented level. We note with much caution that two-thirds of listed Emerging market companies (in various indices) haven't seen any major business down cycle being products of the post-GFC bull-run. We are worried that the market is not prepared for the now decade-long internet cycle to end. Moreover, we are also not sure how the market will behave if some of the tech hardware / product upgrade cycles which have played quite well since the GFC, lose their impact on the global economy. Lastly, we remain sceptics of any great positives from restart of QE programmes by the major Central Banks like PBOC and ECB (as we write, PBOC has restarted QE and ECB is contemplating the same).

Given the above, 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%.

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Why does Chinese economy need stimulus every 3rd year since Great Financial Crisis?

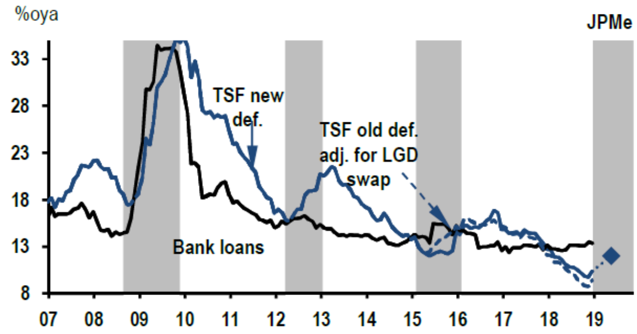
A fundamental question arises as to why a large US$12tn+ economy needs stimulus when it is growing at a 6% rate (as per official data). This, when most of the OECD countries with comparable GDPs are growing at 1-3%, whereas large emerging markets are growing at 3-7%.

A part of that answer lies in what is likely to happen to nominal GDP growth in 2019. As producer price index (PPI) stays at zero and may turn into negative in 2019, the situation could be like 2015 when nominal GDP of China dropped by 50% from 10%+ level in 2014 to 5% or below driven by negative PPI. Similarly, in 2019, we expect China's nominal GDP to drop by circa 30-35% from 9.5% in 2018 to around 6-6.5%. Since for most of the businesses, top line and to large extent bottom line depends on nominal GDP growth, the earnings impact in 2019 could be quite dramatic. Against market expectation of 6-9% earnings growth, we wouldn't be surprised if earnings growth comes down to zero or even becomes negative in 2019 – akin to what we saw in 2015. The other part of the answer lies in veracity of the GDP growth numbers themselves.

We note that this will be the fourth round of stimulus for China – the earlier ones being in 2009-10, 2013, and 2016. This implies two things – a) the vulnerability of current growth numbers and hence corporate earnings, which can hardly withstand any slowdown in credit growth, requiring a need for recurring stimulus; and b) incremental efficacy of these stimuli will keep reducing, simply as the sharply rising debt limits the scope / size of stimulus in every round.

Therefore, for our portfolio, we keep looking for businesses in China where dependence on nominal GDP is low and/ or there is a secular driver which provides very long-term growth trajectory.

Total *Social Financing*



Source: PBOC, J.P. Morgan

Why the current stimulus may be less effective for China?

The current administration started to stimulate the economy grudgingly in mid-2018, when the trade dispute with the US became intense with the potential to cover entire exports under higher tax regime. However, as we mentioned in past, China's slowdown in 2018 is more due to de-leveraging cycle unleashed in mid-2017 rather than trade war. By end of 2018, the govt. pretty much gave up the notion of de-leveraging agenda and started both fiscal stimulus (viz. corporate and personal tax cuts) as well monetary stimulus (pushing for higher lending to SMEs/ private sector as well as QE in the form Bank issuing perpetual securities).

However, we doubt the effectiveness of current form stimulus for the following regime:

A) While the absolute level of tax cuts looks high at RMB2tn relative to the size of the current GDP, this is smaller than the stimulus seen in 2009/13/15. Also, the consolidated fiscal deficit (including off-balance sheet items) may touch 6-8% of GDP, thus limiting the scope for further stimulus. This is in addition to the existing high debt level in the economy.

B) The personal tax cuts may have much lower multiplier impact on economy than

investment led stimulus. Even on Infrastructure spending, after posting a 5-6% growth in 2018, the Infrastructure FAI may grow at around 8% in 2019 – not a large YoY growth.

C) The reduction in VAT may not be retained by all corporate due to the competitive nature of Chinese market, thus having minimum impact on their profitability. Even a 4% reduction in Social Security Fee may not help since this comes with greater compliance by the provincial authorities. Also, to note that deficit in social security fund is rising rapidly to FY19E of RMB1.4tn.

D) Lastly, as the economy grows largely driven by credit growth, the incremental return on investment will keep going down.

Our hypothesis is likely to get reflected in acceleration of earnings downgrade cycle in China. While analysts have cut earnings for 2018 in the past few months, consensus still seems sanguine about recovery, particularly in the cyclical sectors (autos, commodities, industrials, technology) in 2019. In our opinion, this is where a big disappointment may come.

Do you think we will see a repeat of 2015 Boom & Bust cycle in China A-share market?

In 2015, the Chinese government inflated China's A-share market – to reflect their SOE (state owned enterprise) reforms as well as to de-leverage the economy through equity raising. As we witnessed subsequently, the SOE reform was superficial and created more zombie groups through mega-mergers, albeit with little gain in efficiency. Similarly, too many low-quality companies rushing to the equity market didn't help the cause either. A lack of earnings growth and huge margin money balance (RMB3tn at peak) led to a subsequent collapse in the A-share market.

This time, the government again wants the A-share rally to reflect the market's faith in their stimulus, which should additionally serve as a monetary easing tool. We believe that both these objectives stand on weak foundations and we will soon find that lack of earnings growth may eventually lead to an uncontrolled correction. Some of the market participants take comfort from lower margin money build-up this time, and apparently attractive valuations (viz. trading at FY19E P/E of 11.7-12x vs. 2015 peak of 14.6x).

However, we believe this time, the lending into stock market is likely to be happening under the guise of bank lending to SMEs/ private sector and OTC financing which is back in vogue. On top of a relaxation of capital adequacy and margin lending standard for the brokers, will lead to surge in margin financing in coming months.

Lastly, while consensus opinion is that China A-share market is cheap; we struggle to find out the normalized level of earnings. By some analysis, 90% of Chinese corporate listed in Shanghai/ Shenzhen A/B-share markets receive one or other form of government subsidies. As the government start reducing subsidies to many of these industries (as part of the US trade deal and/ or rationalisation process), earnings of these listed corporate (Oil & Gas, Industrial/ Automation, Renewable Energy, Electric Vehicles etc), may decline substantially.

While we have an overweight in A-share market, which did well in 2018 and this year as well in absolute terms, we don't want to change our strategy because of the government orchestrated bull-run in the market, which is based on weak foundation.

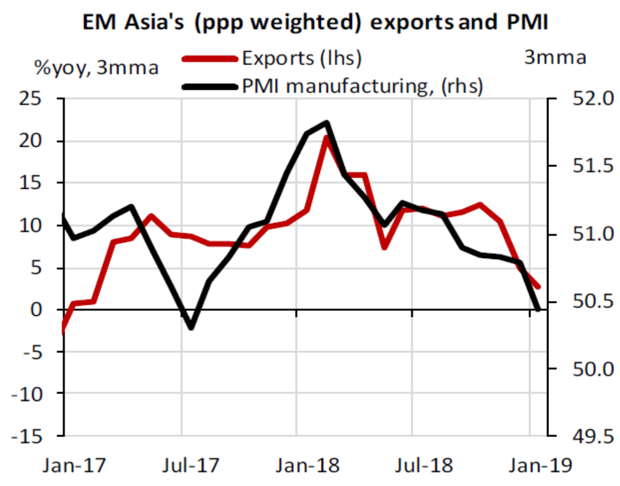
Do you believe that the trade truce will reinvigorate global trade and hence earnings revival?

First, we are not sure if the upcoming trade deal between the US and China will be structurally positive for Global trade/ economy. This kind of bilateral deal between

two largest economies may undermine WTO's role further, which itself is proving less effective in recent years. As China commits to import more commodities from the US (agriculture goods, energy etc.), it has to reduce the same imports from other countries as part of rebalancing trade.

Since most of these exporters are emerging countries, the only way to get out of this situation would be to devalue their currencies, something we witnessed in late 1990s following break-up Former Soviet Union. This may create a deflationary spiral in Global economy, which is already struggling to raise inflation. The deal may also create higher trade deficit for the US against their allies viz. Europe, Japan or Mexico. Needless to say, this would start a fresh round of trade friction, something we witnessed in early 2018.

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. Thus, completion of trade deal between the two countries may not address deceleration of earnings momentum (besides short-term sentiment improvement), to the disappointment of market.



Source: CEIC, DBS Group Research

What is the duration of your portfolio? How do manage the duration risk in the portfolio?

Like all long-dated assets, they key risk for our portfolio is duration risk which unfolds particularly when 'real cost of capital' rises abruptly, something we witnessed in latter part of 2018. As discussed in our Nov'18 quarterly newsletter, we have low expectations about inflation in the absence of a strong wage recovery in most of the economies and muted capex cycle. On top of that, most of the Central Bankers are either pausing their rate hike cycle or embarking on fresh QEs.

The shortest duration within our assets is Chinese toll roads with 15 years of balance concession period, while our longest duration asset is airport asset with 70-75 years of concession left. On top of that, there are many perpetual assets. The average duration of assets in our portfolio is around 30 years.

While it's virtually impossible to hedge the duration risk in our case, we focus on three qualities of assets/ businesses to reduce this risk: - a) moat characteristics, which also give them pricing power to offset any above the trend inflation, b) secular trend of the business, which gives long term visibility of traffic growth, c) liabilities and interest obligations, are well matched by assets and underlying cash flows. Lastly, in many cases, assets are perpetual in nature or have options to lengthen the concessions.

How do we see the NBFC crisis unfolding in India in coming months and what will be the collateral damage?

Despite the fall in oil prices in the fourth quarter of 2018 and moderation of the US dollar strength against emerging market currencies, we continue to stay underweight on India. We concede that there could be higher chances of the ruling party coming back to power for a second time in the forthcoming elections in

2019, having made significant gains recently owing to India's skirmish with its neighbour, Pakistan. However, our cautious stance on the Indian market is based on a few fundamental factors, which are less likely to change in near term.

A) We are yet to understand the full gamut of NBFC crisis which is driven by the lending spree they embarked on following demonetisation, which led credit mutual funds becoming a large source of funds for them. NBFCs aimed to fill up the gap created by PSU banks and extended their lending to the Infrastructure sector, real estate developers, etc. thus creating large asset-liability mismatch. A lack of adequate project appraisal skill or NPA recovery mechanism has already started haunting them. Given the disproportionate role of NBFCs in credit market (35-40% of incremental lending to corporate in past 3 years), their withdrawal should impact lending activity in real estate, consumer durable sector to name a few.

B) The true size of the fiscal deficit, and the trend ahead, could be much higher than the official estimate of 3+% due to a persistent GST collection shortfall, albeit mitigated this time by a large-scale divestment of PSU stocks, and a likely one-time large fund transfer from the RBI. The starting of Universal Basic Income (UBI) for marginal farmers is likely to a recurring drain on precious resources without any real improvement of the targeted class (something we saw in Public Distribution Scheme).

C) Other factors like lack of job creation or creation of poor-quality jobs and unprecedented agrarian crisis;

D) The rate cuts are unlikely to help SMEs or corporate as deposit growth is falling well short of credit growth besides very high level of NPAs in banking system;

E) As the fiscal stimulus unwinds after election, economic growth may decelerate further – something we are already witnessing (as in the last quarter of 2018);

F) Lastly, valuations remain at a large premium to emerging markets despite recent correction. The earnings are coming down rapidly for the fifth consecutive year, viz. the estimate of 20% earnings growth in FY19 has already come down to below 10%.

The demonetisation had created illusion of unprecedented liquidity which led to a surge in mid-cap stock prices and valuations reached to an unprecedented level. This was further fuelled by unbridled optimism among private equity funds – both foreign and domestic alike. However, as this excess liquidity slowly unwinds (as reflected in NBFC liquidity crisis), the mid-cap stocks may continue to de-rate. The incessant earnings decline doesn't help either. Lastly, while the damaging effect of demonetisation on economy is now well known, the fact remains that the currency in circulation today is 40% higher than that of 2016 (pre-demonetisation level) – a travesty of the entire exercise.

How do you play the secular trend of emerging market students going to English speaking countries like the US, UK and Australia?

Our portfolio strategy focuses on businesses with lesser dependence on nominal GDP growth. We believe that the drivers for economic growth have changed since GFC. The traditional drivers like increase in labour force and higher labour productivity are now replaced by increase in asset prices and wealth effect. This implies two things: globally, the central banks will aim to keep real cost of capital as low as possible – a tailwind for infrastructure sector. Secondly, the infrastructure activities, which by nature are secular in nature, will grab higher attention due to long term predictability in a slow-moving world.

In this context, we believe that the business of Student Accommodation fits well in the above strategy. We believe that the Emerging countries like China, India, Vietnam, South Africa will continue to send their students to English speaking countries – primarily USA, UK, Australia and Canada. The long term forecast of double-digit growth of such students looking for higher education will create a need for accommodation within and outside University Campuses. Given limited availability of hostels within Campuses, there will be a greater need for well managed Student Accommodation in the vicinity.

Unfortunately, there are not many assets which are in the listed space and most of the deals happen in private markets. This said, our portfolio owns Asia's only listed company in Student Accommodation, which has the unique advantage of offering integrated services. Besides owning the assets, the company manages these assets (earns management fees), carry out asset enhancement exercises, as well as, is in position to manage third party assets as well. Most of their assets are perpetual in nature and located in prime locations in the UK and Australia. Additionally, they also have some US assets that are held in a fund structure as a part of asset light approach. Unlike private equities with large pool of capital, the company has taken a prudent approach to buy assets with USD cap rates of 6% to 8% (with hurdle rate over 5.5%). Besides secular volume growth, the assets also enjoy pricing power in the range of CPI+ rate.

Top 3 Country Allocations	Portfolio (%)
Australia	16.6%
China (HK)	14.5%
Singapore	12.8%

Top 3 Equity Holdings	Portfolio (%)
Bingo Industries Limited	6.1%
Freightways Ltd	6.0%
Sydney Airport	5.6%

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