JN Asia Infrastructure Fund SP

Newsletter QE 31st May 2019

Dear Investor,

This is the quarterly newsletter of JN Asia Infrastructure Fund ("the Fund" or "JNAIF") for the quarter ending 31st May 2019.

The Fund currently manages total assets of **USD10.2mn** as at the quarter end.

For the quarter, the Fund has delivered returns of **1.97% gross of fees** and **1.65% net of fees**. In this period, the reference benchmark (MSCI Asia-Pac ex-Japan) posted **(-)4.57% return**. Since inception, JNAIF has delivered **11.43% (gross)** and **9.24% (net)**. On a relative context, this translates to cumulative outperformance of **25.4% (gross)** and **22.9% (net)** vs. MSCI Asia-Pac (ex-Japan).

The May quarter turned out to be similar to the previous quarter. But unlike the previous quarter, this one started on a strong footing driven by China's soaring stock market but ended with a big meltdown in May triggered by a fresh round of Trade-war, followed by weak economic data from China. However, there was a strong dispersion across markets. While Chinese stocks declined sharply, Australia, India and Indonesia stood out well with strong gains. All three markets gained from continuation of leadership and tailwind from Central Banks' rate cuts. Our portfolio tilt towards secular growth stories with underweight stance to North Asia helped our portfolio to perform well relative to the broader market and as Infrastructure Universe.

Going forward, we see a number of tailwinds for our portfolio viz. continuation of the US Fed's dovish stance which should create a peak for USD vs. Emerging market currencies. The others would be proactive fiscal policies by the newly elected governments in India, Indonesia and Australia, which should be well supported by rate cuts by the respective central bankers. Even though trade related noises and economic slowdown will continue to dominate market sentiment, this doesn't surprise us as we always believed that economic issues from over-leveraging, low growth and deflation are much more structural in nature. Our discussion ahead seeks to give further details into our thought process at this point.

What do you mean by "growth is dead"? How does this impact your portfolio positioning?

We believe that it will be increasingly hard for traditional economic growth models to sustain, given high levels of debt in economies, declining productive populations and slowdown in some of the largest global growth engines. That is our primary premise behind our belief that "normalised growth" as we know it is dead. To elaborate further, GDP growth is essentially a function of growth in labour population and increase in productivity. In most of the developed economies, labour population has already peaked out with ageing population. Unfortunately, Internet 2.0 revolution hasn't added much to productivity. As a result, since GFC, we got an intermittent burst of growth in most of the economies (outside the US), which was largely a function of fiscal and monetary stimuli working in tandem.

No wonder then, since GFC, PBOC has embarked on its fourth QE programme, ECB is contemplating its third QE and Japan is on a perpetual QE. Meanwhile, the US Fed has already stopped its quantitative tightening programme and has now indicated a potential rate cut in 2019.

The need for perpetual stimulus in the global system implies two things – a) Japanisation of the Global *economy* is on its course, which reflects vulnerability of current growth numbers and hence corporate earnings that can hardly withstand a slowdown in credit growth, and b) incremental efficacy of these stimuli will keep reducing, simply as the sharply rising debt limits the scope / size of subsequent stimulus rounds.

For past 20 years, since entry into WTO in 2001, China has been the biggest engine for World's

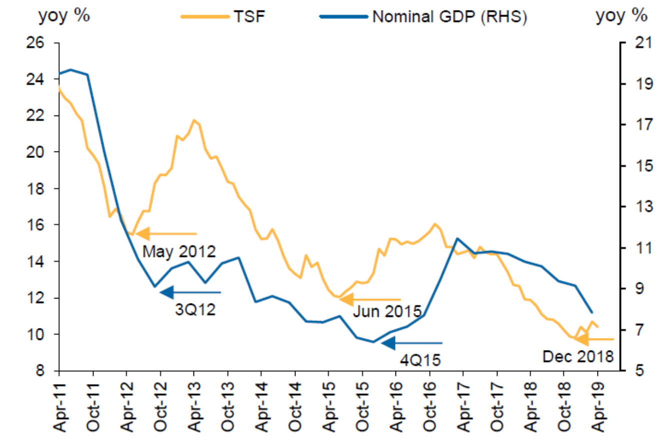
economic growth. Further to this, since GFC, China has single handedly contributed to 40-50% of the Global nominal GDP growth. However, this engine is cooling down rapidly. Despite official forecasts of GDP growth at circa 6%, China needs fiscal and monetary stimulus in 2019 as its nominal GDP may fall much more sharply than real GDP (our estimate: 30% on YoY basis). Decades of Infrastructure stimulus has reduced its effectiveness substantially, while monetary stimulus has its limitation due to very high leverage in the system. In Q1 of 2019 alone, China has added 2.5% debt to its GDP. Their declining labour pool, which peaked out in 2015, will drag its GDP further. In 2018, the number of births was less than 2015 when one-child policy was formally abolished.

Given this background, we are surprised to see a common discourse among brokers, investors and major corporates that the Chinese government has enough ammunition to reignite growth in the old-fashioned way, without creating much negative side effects (viz. 6% growth on US$13 trillion economy is 12-15% GDP growth 10 years back when China was a US$5 trillion economy). Most of these corporates are not prepared for a structural slowdown, not only in developed economies, but also in most emerging economies viz. China, LatAm, Eastern Europe etc.

The other difficulty is to assess normalised earnings given that one or the other form of monetary and fiscal stimulus is in the system. Thus, we need to readjust earnings growth expectation and real cost of capital while valuing an asset/ business/ corporate.

Having said that, Asia with about 6-7% nominal GDP growth stands high vs. all other geographies. Within that, we adopt two prong approach – a) Focus on countries which still have superior growth on normalised basis viz. Emerging Asia (ex-China), and b) Continue to focus on businesses / companies where we see delivery of earnings on a "sustained basis" even at a much lower than historic growth level, without recourse to any form of stimulus or subsidies. This explains why our expectation of average earnings growth stands at a modest 6-8% with a dividend yield of 3.5-4%, but that stands tall in an environment when *normalised growth is dead.*

China's Credit Growth vs Nominal GDP



Source: CEIC, Wind, Macquarie Macro Strategy, June 2019

Given the breakdown of the US-China trade talks, does your portfolio get impacted?

A simple answer to this will be, not much. Most of our portfolio names don't get impacted directly with the trade war, even though we may have some indirect impact through negative sentiments impacting corporate investment. However, our exposure to ASEAN, which is a likely beneficiary, should compensate for that.

We would like to reiterate two key points made repeatedly in our past newsletters. A) The current form of the trade deal between US and China is not necessarily a good outcome for the medium term as it doesn't solve the current Global trade imbalances, while further marginalising the post-World-War Global institutions that created rules-based trading. Moreover, a bilateral trade deal could further marginalise the interests of smaller countries, while creating another front of battle between the US and the European Union. B)

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 weak earnings is largely due to its own country specific reasons.

In addition to this, we also believe a trade deal notwithstanding, will not solve the Geopolitical rivalry between the two superpowers. Given the divergent ambitions, different values, governance and lack of incentives particularly on the US part, we don't see how we could see a durable trade peace between the two largest economies in the world. As we write this newsletter, the above situation is becoming more apparent.

Thus, with or without trade deals, we believe that Chinese corporate earnings will continue to struggle in absence of structural reforms. As soon as the fiscal impulse goes down, the earnings trajectory deteriorates very quickly as reflected in Q4'18 and Q1'19 earnings of Chinese B-share companies and Chi-Next. It's bit of a travesty that when in May'2019, MSCI increased its weightage of Chinese-A shares, we saw the fastest outflow of foreign investors from Shanghai and Shenzhen markets.

Therefore, notwithstanding intermittent bursts of earnings improvement, factors like – a) inefficiency in Chinese SOEs with bloated balance sheets, b) half-baked market reforms with no clear pricing deregulation, c) rising tariff/ non-tariff barriers for Chinese exporters, d) rapid slowdown in new economic sector, and, e) NPA heavy Banks' balance sheets, will keep earnings momentum at much lower levels. On top of that, the removal of government subsidies in sectors viz. renewable energy, New Energy Vehicles, Automation, will make earnings prediction even more difficult.

In view of the above, we continue to focus on a few sectors which don't depend on the government subsidies, are less impacted by 'trade noises', and enjoy visible long-term cash earnings growing at around nominal GDP growth rate.

Do you think the new govt. in Malaysia making an about turn in policy reforms may adversely affect economic growth?

We don't believe so. After initial setbacks, we believe that the new government is on the right track through strengthening institutional framework and broad basing economic reforms. This, however, takes time to show results.

Thus, from a medium-term perspective, at this stage, Malaysia offers an interesting opportunity. Within Asean markets, Indonesia and the Philippines are the two most overweight markets for investors because of their demographics, higher GDP growth and lower 'debt to GDP ratio'. Malaysia also suffered from tainted image of the previous government. However, we form a constructive view on the market for the following reasons:

a) The current government has embarked on a grassroots level reform, while building up or strengthening existing institutions. By reducing ministerial discretion, building up rules-based policies, the government may build a solid foundation for next leg of economic growth. Government Linked Companies (GLCs), which represent circa 40% of Bursa Malaysia's total market cap, are likely to benefit from greater operational freedom and professional management.

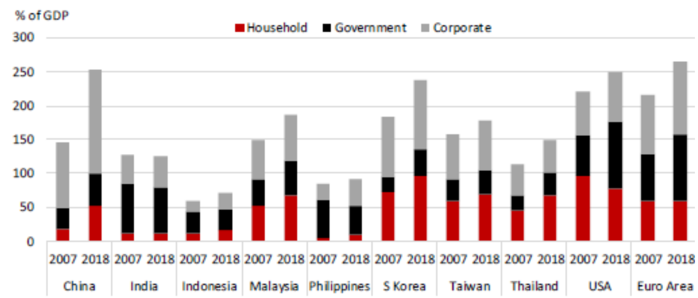
b) Most of the Chinese backed projects have been renegotiated with much lower project cost and improved economics. Restarting these projects in the second half of 2019 can improve Malaysia's GDP growth profile. Amending its relationship with China may also bring back Chinese tourists. Note that we have seen a marked slowdown in Chinese traffic in the past one year.

c) Malaysia boasts one of the best infrastructures among the ASEAN countries (outside Singapore) and is very well positioned to benefit from relocation of some of the manufacturing facilities outside China due to the ongoing US-China trade war. Superior infrastructure (land, water, power, and logistics) can outweigh concerns like skilled labour shortage.

d) Lastly, the country ranks high on parameters such as corporate governance, quality disclosures, cheap currency, and is the only Asian country with a positive oil & gas trade balance.

We continue to stay modest overweight on Malaysia through selective exposure to high quality infrastructure names, which have substantial moats and enjoy strong free cash flows, having completed their expansion plans in the past few years.

Gross Debt to GDP Ratio



Source: CEIC, BIS, DBS

How are you positioned in Indian logistics space? Why is there a tremendous interest from Private Infra players in this space?

Indian Logistics space is attracting capital at this stage for the following reasons:

a) Post GST implementation, the need for having manufacturing facilities in multiple states to earn sales tax advantages doesn't exist. The manufacturers will likely need to have large, efficient manufacturing facilities in a single location. They would like to distribute products efficiently through a hub & spoke system of warehouses across the country.

b) The quality of existing warehouses is quite inferior at this stage, thus the need for building class-I warehouses in multiple locations. Only 10% of existing warehouse space in India qualifies as Class-I at the moment.

c) Rising penetration of e-commerce drives the need for larger fulfilment centres and quality warehouses closer to the customers. Also, players like Wal-Mart, Reliance Retail focusing on market place solution, will integrate the last mile retail stores, bypassing the distributors. This may lead to a greater need for distributed warehouse and an efficient last mile delivery service.

d) Given scarcity of land, high cost of capital, the entry barrier will remain high in this space, particularly for those infrastructure assets which are well connected to railways or located closer to port.

e) The penetration of third-party logistics (3PL) in the country is low, partly due to poor infrastructure and lack of countrywide tax system. With implementation of GST, the need for better management of inventory through third parties will become more attractive. This creates a substantial opportunity for 3PL players, particularly in Automobile, FMCGs, Pharma space.

Several private equity funds and infrastructure funds have formed JVs with local partners to build Class-I warehouse space in India. Among listed players, Container Corporation has an impregnable position in terms of access to railway infrastructure, both Inland Container depots, and Port based container freight stations. The company has also built up

several Private freight terminals along upcoming Dedicated Freight Corridor. A large part of this advantage is however reflected in Container Corporation's expensive valuation. On top of that, they are being price takers, since ad-hoc railway pricing continues to impact their profitability.

Our fund has exposure to Class-I warehouse facility, which is located in the vicinity of India's largest container port – JNPT. We also have exposure to one of the fastest growing 3PL player, which operates using an Asset light model while the parent group acts as an Anchor customer.

How do you see the fund's allocation to India change post-election?

In the past few months, we have raised our allocation to the Indian market post correction during the Jan-Feb'19 period. However, this remains stock specific where valuations look reasonable and meet our moat characteristics. We continue to avoid taking a blanket call on the market as well on economic recovery.

In fact, we believe that a combination of tight credit market with rising defaults by Shadow Banks (NBFCs), high joblessness in the economy, slowing corporate capex cycle and limited fiscal space for the State as well the Central government, will keep the economic growth at a moderate pace in medium term. This coupled with low inflation will keep nominal GDP growth at 10-12%, well below historic average. This in turn, will lead to a poor earnings momentum like what we saw in FY15-16 period, contrary to current market expectation of 20% growth in FY20-21E period.

On top of poor earnings prospects, the valuations remain at elevated levels and with the recent correction in Emerging markets, India's P/E multiple premium to the EMs has gone back to its historic high level.

While the above factors prevent us from going overweight on India, we have added to our India position driven by some macro positives and some bottom-up idiosyncratic stories. India continues to have one of the highest real interest rates among all Emerging markets. With credit growth lagging nominal GDP growth, the rate cuts can go on for quite some time. A combination of lower oil prices, weakening USD, a likely improvement in government revenues through better GST implementation, and completion of mega - election exercise, should see liquidity improving in coming months. This in turn, should improve credit transmission mechanism in coming quarters.

We also believe India could be an indirect beneficiary of ongoing trade conflict between the US and China. While Vietnam, Taiwan and Malaysia have seen some immediate benefit from rerouting of Chinese exports, India should eventually see some relocation of manufacturing facilities, largely attracted by its large domestic market.

Lastly India, Indonesia and the Philippines remain some of the few domestic focused economies with young demographics and a normalised GDP growth over 5%. While several market participants are optimistic about prospect of economic reforms to be unleashed by re-election of incumbent government with a large mandate, we remain sceptical. We believe that due to lack of talent in the current Cabinet of ministers and lack of appetite for any path-breaking reform, most of the economic measures will be incremental at best.

How do you play a secular theme like migration of Asian students to Western universities?

We continue to like the Education space, which has secular tailwinds. 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 low – 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.

We believe that the Emerging countries like China, India, Vietnam, South East Asia will continue to send their students to English speaking countries – primarily USA, UK, Australia and Canada.

The rising income levels and growing middle class in countries like China, India and SE Asia will continue to drive students seeking higher education in countries like Australia, Canada and UK. The US, which is the largest destination will continue to retain pre-dominant position given the size of its job market, the number of its globally acclaimed universities etc. However, increasing restrictions to student and job visas to overseas students, will likely make the US a less attractive market. Worth noting though, that the UK, despite Brexit uncertainty, continues to attract a large number of students from Asia. We think that this number is likely to rise further post Brexit, as the global acclaim of the UK's universities should remain intact, while at the same time, an arguably weak Pound should help. On the other hand, additional costs and restrictive visa policies for the continental Europeans could raise barriers for European students.

The above scenario should lead to a double-digit growth of such students looking for higher education in the medium term. This creates several opportunities in the social infrastructure space, such as: a) Companies which carry Internationally recognised English proficiency test, b) Student Placement in various universities, c) Online/ Offline education with tie-ups with Universities, and d) Student accommodation within and outside University Campuses.

We have discussed the Student Accommodation business in our last newsletter, a sector which should enjoy secular tailwind in years to come. Given limited availability of hostels within University Campuses, there will be a greater need for well managed Student Accommodation in the vicinity.

For the first two segments (A & B), there are very few listed entities which enjoy the Global franchise as well as tie-ups with Universities in some of these countries mentioned above. The entry barrier is very higher given – a) need for globally accepted brands for English proficiency test – viz. TOFEL, IELTS and Pearson, b) long term relationship with the universities of global standing, and c) long gestation period to build necessary online/ offline infrastructure in Emerging markets, which are the catchment areas for student sourcing.

Given the above, we like IDP Education which has a global standing in each of the above areas and enjoys strong secular tailwinds. The migration to online will bring further efficiencies and cost improvements. Their pricing power and improving student mix towards post-graduation will improve operating margins further.

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Newsletter QE 31st May 2019

Country Allocation	Portfolio %
Australia	16.2%
China (HK)	15.0%
Singapore	12.1%
India	10.3%
Philippines	9.9%
New Zealand	8.4%
Hong Kong	7.4%
Indonesia	6.6%
Malaysia	5.4%
Thailand	4.5%
Cash	4.3%

Sector Allocation	Portfolio %
Highways & Railtracks	13.8%
Health Care Facilities	10.6%
Waste Management	10.6%
Industrial Real Estate	9.9%
Air Freight & Logistics	9.7%
Airport Services	9.0%
Gas Utilities	7.8%
Telecom Services	6.6%
Electric Utilities	4.8%
Others	12.8%
Cash	4.3%

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