JN Asia Infrastructure Fund SP

Newsletter Quarter Ending 31st December 2019

Dear Investor,

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

For the quarter, the Fund delivered returns of **9.5% gross of fees** and **8.9% net of fees**. In this period, MSCI Asia-Pac ex-Japan posted **10.1% return** while MSCI Ex-Japan Infra Index posted **3.5% return**. The quarter saw risk-on rally as many of the recent concerns abated. De-escalation of US-China trade wars, politically clarity around UK's exit from the European Union and perhaps tepid news flow from HK.

Overall, for the calendar year 2019, the MSCI Asia ex Japan index had a good year **up 15.8%** with most of the run-up concentrated in the last quarter and primarily led by tech stocks. Also, for the calendar year 2019, MSCI Ex-Japan Infra Index posted **5.4% return**. Despite the high beta rally across the broader market, we outperformed market with returns of **19.9% gross of fees** and **18.0% net of fees**. This was driven by stock selection, characterised by secular earnings growth and low correlation to the broader market.

We are using the current rally to selectively reduce our positions in stocks that have become expensive. There are still pockets of opportunities and we have been deploying cash over the past month to scale up our positions in China, Taiwan and New Zealand. Over the prior two quarters we had built up positions in the stressed markets of India and HK which has played out well.

Going into 2020, we believe the risk-on rally could face challenges given neither the near-term political issues nor the long-term economic growth issues are yet resolved. The US-China trade relation may go through multiple ups and down, while the political situation in HK and India may remain unpredictable. China's ongoing monetary stimulus may just keep the economy running around 6% level rather than leading to any desirable spurt in investment. We believe, the optimism around rebound in emerging markets and Asian economic growth is now a consensus trade.

We put less emphasis on taking macro calls on economies or markets and rather focus on companies that have secular and less-correlated business models with more predictable earnings.

What do you mean by 'Ethical Capitalism' and how is this different from the focus on ESG that is sweeping the fund management industry?

At a first glance, 'Ethical Capitalism' sounds like an oxymoron. Capitalism is largely driven by profit maximisation objective. However, we believe 'Ethical Capitalism' ensures sustainability of that profit over a longer period by taking interest of all stakeholders into consideration. Prior to the GFC, we saw companies embracing creative accounting, taking undue balance sheet risks and skewed incentive structures that lead to short term profit growth. But this came at the cost of long-term profitability, economic growth, and wealth creation for a larger constituent of society. Though this edifice collapsed during the GFC, the basic underlying philosophy remains for many companies.

We believe a resilient business model requires a corporate to be considerate of all stakeholders viz. employees, customers and shareholders and think of long-term value creation rather than short term profit maximisation. We term this a '*Golden Trinity*' where corporate aim to keep its employees motivated with a calibrated incentive structure, while exceeding its customers' expectations. This leads to a sustainable profit which is typically well rewarded by the stock market leading to gratified shareholders. Only a handful of companies in any country meet this seemingly simple but difficult to practice concept. We are always on the lookout for such companies and believe these companies represent the core holdings of our portfolio.

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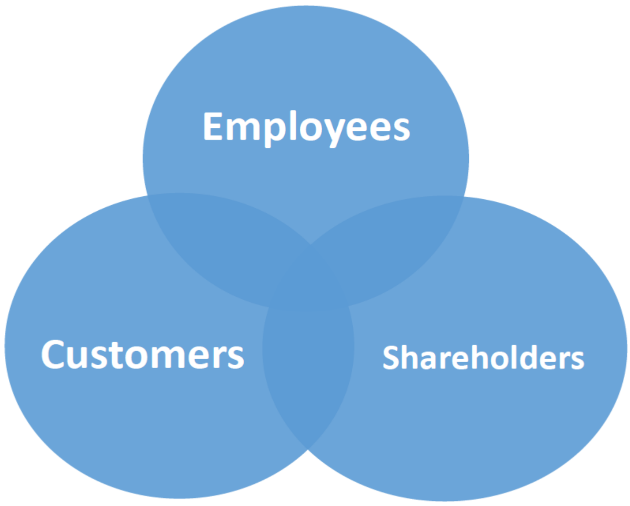
Most companies unfortunately only focus on trying to maximise only shareholders' value. This is derived from short-term measures like reducing number of employees to cut costs, market skimming strategies, misleading product campaign to customers, avoiding onerous environment compliance cost or unbridled M&A driven growth. In the short-term it leads to higher stock prices and pay-outs for the top management. But, in the medium to long term this strategy fails to deliver with disgruntled employees, weaker brand value and eroding business proposition.

'*Ethical Capitalism*' is qualitatively different from ESG. ESG nowadays is getting bucketed into quantifiable measures like level of greenhouse emission per unit of sales, energy consumption per employee or per unit of production etc. which sometimes gives a skewed view without considering the holistic picture. Ethical Capitalism on the other hand doesn't take a moralistic stance based on a narrow view of environment measures without taking into cognisance the nature of the industry. For example, mining or hydrocarbon industry are polluting but still essential and might continue to play a critical role in the modern economy for a foreseeable future. Even in modern industries like electronics and robotics, most of the critical elements required to need rare earth metals and mining those is highly polluting.

Similarly, a waste recycling company consumes more energy than say business staffing company or an online tourism company. A straight-line approach of ESG measurement might end up having an opposite effect of pushing down the waste management business lower in ESG ranking within the industrial group, undermining the criticality of waste recycling company in our economy. Sometimes, a limited application of ESG concepts can distort its linkage with long-term shareholder value creation.

On other hand, the linkage between Ethical Capitalism and shareholder's value creation is strong as seen in multiple cases. Companies like Ryman Healthcare - New Zealand's largest retirement house, Costco Retail, Salesforce in US, Asian Paints in India are some of the examples. The organisations that create a culture of fairness, honesty, and respect, reap the rewards in long run. They attract motivated staff which stay in the company for a long period. These companies pay great attention to employee morale and link employees' incentives with customers' satisfaction. These organisations focus on ethical usage of products rather than market skimming strategy. And, when these companies acquire a company, they not only look for technology, market, products, but also look for the culture, ethics and the leadership.



In conclusion, ethical capitalism is one where a company values all their stakeholders; their customers, employees, and shareholders. These companies believe stakeholder return is as important as the shareholders' return.

Are we at end of third wave of globalisation, what are the investment of implications?

First phase of globalisation started after second industrial revolution and ended before the first World War. The deglobalisation that followed also coincided with two World

Wars. The second wave of globalisation started after Second World War and ended during the break-up in Brenton Wood agreement. This was followed by a period of equilibrium. The third wave of globalisation started with break-up of Soviet Union and fall of communism in Eastern Europe. This was accelerated with China's entry into the WTO.

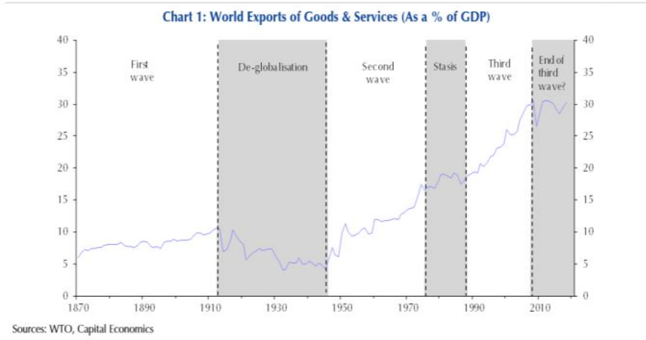
However, pace of globalisation has slowed markedly since the GFC. We are likely at the end of third phase of globalisation, only history will tell for certain. But the US-China trade dispute reflects that the current trading system has outlived its utility. Unless substantial changes happen in the way WTO functions (unfortunately WTO cannot do that on its own) more bilateral deals and disputes will dominate the global trade system. Balkanisation of global trade system is also leading to many regional trade blocks like RECP treaty, revised NAFTA treaty, Brexit related deals, etc.

Technology revolution in manufacturing like Industrialisation 4.0, 3D printing and changes in consumer's habit towards 'experience' rather than buying tangible goods, will further accelerate localisation of manufacturing albeit at gradual pace. Further, China's desire to set up an independent ecosystem using their own technology (something Russia tried to do during Cold War), may lead to further disentanglement of technology supply chain.

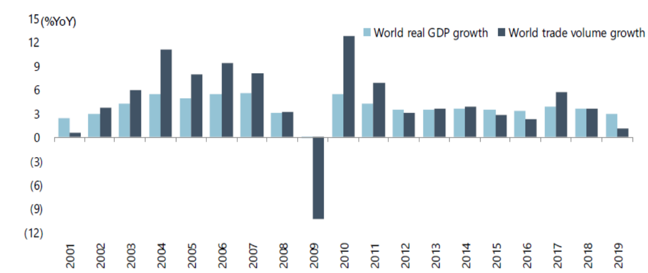
However, we believe globalization is a multifaceted phenomenon, comprising of people, culture, capital and goods. It has been a constant since the dawn of time, but it also has a cyclical nature. Throughout human history, there have been periods where globalization was interrupted. Eventually, it always resumed. The desire for prosperity means that flow of capital, information, technology and demographic will persist. However, for the short-term trade and cultural globalization will likely take a step back, as nationalist agendas gather momentum.

The investment ramification could be far reaching and have multiple dimensions. This is already reflected in the massive slowdown in global trade volume growth. During the period of 2001-10, global container volume grew 2-3x of GDP growth, which slowed down to 1x GDP growth in 2010-18 period. Since then, this growth has come down to practically 0-0.5x of GDP growth. We believe, ongoing localisation and reshoring of manufacturing particularly in technology supply chain, could lead to further disruption in global trade.

Waves of globalisation - at end of the third wave…



World real GDP growth and trade volume growth



Source: IMF Forecast 2019 – World Economic Outlook – Oct 2019

On the positive side, a greater share of spending towards 'experience travel' will continue to drive demand for transport infrastructure like airports, roads, and for other correlated travel like education (student accommodation), medical tourism, etc.

JNAIF has significant exposure to these infrastructure assets which cater to flow of people and information. JNAIF has limited exposure to port assets, which may face a headwind from de-globalisation. The port

asset we own is largely exposed to regional trade rather than trans-pacific trade. Regional trade will continue to thrive due to balkanization of global economies.

What do you think of the rising regulatory risks in countries like Malaysia and the Philippines?

In our previous newsletter we wrote that Emerging Market (EM) as an investment thesis is less valid in today's slowing world. It mainly serves the purpose of index marketeers or ETF sellers rather than funds who seek alpha through active fund management. The key premise for investing in EM was; superior economic and earnings growth, cheaper valuation, benefits from rising globalisation etc. Now many emerging markets have lower growth than developed markets thanks to declining population along with diminishing labour and capital productivity. Further, EM valuation discount is optical and essentially a function of index constituents that have dominance of financials, commodities, cyclical or government owned stocks that trade cheap (probably for the right reason). Businesses with durable earnings like consumer staples, healthcare, infrastructure asset owners or Internet companies, trade at high multiples independent of EM or DM label.

Most importantly, even after 30 years of EM investing, corporate governance and institutional framework remains poor while government interference remains high. Arbitrary regulatory interference jeopardises long term investment and reduce country's investment attractiveness.

Amongst the key markets, corporate governance in China is poor. Even in Korea, which is part of OECD, protection of minority shareholders and their value creation remains unsatisfactory.

Getting back to Malaysia and the Philippines, the recent government actions reflect both crony capitalism and lack of appreciation for the importance of long-term capital.

The Philippines government has threatened to cancel extension of water concessions in Manila city beyond 2022, which were signed in 2009-10, citing clauses that were unfavourable for the government. Trigger point has been the water crisis in Manila city last year, where rising water demand is not being met by increase in water supply, exacerbated by El-Nino. In the past 20 years, private water companies did a commendable job in improving quality of water delivered in Manila, increasing coverage by 2-3x and reducing non-revenue linked water usage by 80%. However, a delay in approving new water source (construction of water dam) by the government, and recent arbitrary reduction in regulated return created uncertainty about investing in the sector. This eventually led to shortage of water last summer. At the same time, the government's penchant to support certain business group further complicated the situation leading to potential cancellation of water concession contract.

We believe that if the Philippines government follows up with this threat, The Philippines could find it extremely difficult to attract long term capital, particularly in infrastructure sector. This would hinder the progress on expected capital flows from China and Japan. The Philippines is the only ASEAN country where Chinese investment is largely restricted to casino projects rather than any meaningful infrastructure projects.

In Malaysia, the Airport regulator (MAVCOM) set up during the previous government regime has been disbanded recently and merged with Civil Aviation Authority. The main reason being MAVCOM's good progress made in laying out a transparent regulatory framework. It created a level playing field among airport operators and airlines, brought transparency in the investment framework and reduced scope for government

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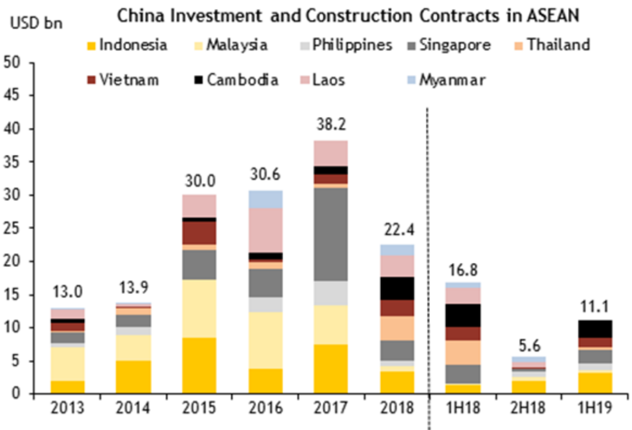
interference. However, on insistence of the country's largest airline, the Malaysian government disbanded an entire regulatory body. This move brings significant uncertainty to long term investments in this vital sector, creates unfair competitive environment amongst airline companies and erodes market value of the government's own listed airport company.

Ironically at the other end, due to lack of focus and technical deficiencies of Malaysia's Civil Aviation Authority it has been recently downgraded as category 2 nation by the Federal Aviation Administration of the USA. Bangladesh, Thailand, Costa Rica, Curacao and Ghana are the only other nations in category 2. Malaysia now cannot open new routes to the U.S. or codeshare with American carriers. It also means Malaysian aircrafts will be more closely monitored at U.S. airports.

We have seen similar moves in Indonesia in gas pipeline businesses (interference in distribution margins) and in toll road tariffs. India has also had its own share of political interferences viz. cancelling projects or changing project economics. We have seen reduction in tariffs in renewable sector in states like Andhra Pradesh, M.P., cancellation of projects like *Amaravati* (Andhra Pradesh' new state capital), etc. We remain surprised by the eagerness of foreign investors, especially pension funds of investing in India's infrastructure sector where the government has large interference in pricing as well as return. We are not surprised that India hasn't benefitted much from ongoing relocation of China's manufacturing facility following US-China trade dispute.

Government interference and weak institutional framework makes investing challenging; a) it creates more uncertainty in the sector and reduces sector multiples, and b) it creates uncertainty about the investment climate in that country eventually leading to another round of de-rating. Within JNAIF when investing in Emerging Asia, we try to avoid owning infrastructure assets that have high exposure to regulatory risk or government acts as a counter party.

China's Investment & Construction Contracts in ASEAN Doubled to $11bn in First Half of 2019



Source: Nomura

Acquisition spree by Singapore REITs/ property funds – does this create value for minority shareholders?

In 2019, we saw a surge in M&A driven growth ($13bn) for Singapore REITs (SREITS), which was funded by large equity raise and cheap debt. This also led to a re-rating of the sector. SREITS benefited from lower interest rates which reduces cost of debt and lowers expectation of return on equity, thus attracting a larger universe of investors.

With regards to M&As, the effective increase in dividend per unit (DPU) - the key metric for REITs, however, has been uninspiring (~1-3% in most of the cases). Despite asset base going up 20-80% in various cases (which benefits asset managers through higher fees), the effective increase in DPU is mid-single digit at best. This is primarily due to most of the assets being purchased at close to full market prices, (unless they are purchased from the sponsor or parent company) and incremental value addition by the asset owners being quite minimal. Most of the earnings accretion reflects cheaper debt and, in some cases,

unhedged debt in Euro or Yen, while assets are in AUD or USD.

However, there are exceptions particularly in the industrial space where the REITS have tried adding value to shareholders the right way. These REITs are converting old industrial space into high tech-buildings which can facilitate Industrial 4.0 manufacturing or into data centres which can add substantial value. The second part of value addition comes from addition of land bank with longer tenures. Given shortening of industrial land tenure in Singapore, land bank additions in Australia or Europe or even in US, where most of the land is freehold by nature, have increased average land tenure for these REITs.

Currently, a large part of equity dilution is due to the debt to capital ceiling of 40% for Singapore REITs. In most of the cases, the equivalent Interest coverage is 5-7x, which is quite conservative given the low interest regime and stable nature of these businesses. An enhancement of the ceiling to 45% can create higher DPU accretion while reducing the need of equity raising for Singapore REITs.

On valuations, despite significant re-rating of Singapore REITs, their dividend spreads over 10-years bond yield remained stable. SREITs have not fully benefited from the last leg of yield compression over the second half of 2019. Spreads are still at long term average of 360bps over to 10-year government bond yield. Only some of the larger REITs are trading at a lower spread of around 200-250bps.

JNAIF's approach to this space has been calibrated, focusing on REITS with - a) businesses that have longer runaway, b) companies with sponsors' assets, which are significantly larger than the one listed so far, and c) managements that have a track record of creating value through Asset Enhance Initiatives (AEI) rather than a pure M&A based growth.

SREIT yield spread vs 10yr Singapore yield

Source: CLSA, Bloomberg

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JNAIF portfolio snapshot at end of Dec 2019

Calendar Returns	2017*	2018	2019	Annualized
Fund (Gross of Fees)	2.66%	-0.88%	19.88%	9.61%
Fund (Net of Fees)	2.27%	-2.03%	18.02%	8.04%
MSCI Asia Pacific Ex-Japan Index	1.59%	-16.25%	15.85%	-0.66%
MSCI Asia Ex-Japan Infra Index	1.08%	-8.65%	5.39%	-1.25%

Country Allocation	Portfolio %
Australia	15.1%
China (HK)	13.5%
India	13.1%
Singapore	11.0%
Hong Kong	11.3%
New Zealand	8.4%
Philippines	7.4%
Indonesia	6.7%
Malaysia	4.5%
Thailand	3.8%
Taiwan	3.2%

Sector Allocation	Portfolio %
Highways & Railtracks	16.1%
Waste Management	14.5%
Air Freight & Logistics	13.9%
Health Care Facilities	9.8%
Industrial Real Estate	9.7%
Airport Services	8.6%
Telecom Services	6.7%
Gas Utilities	5.3%
Electric Utilities	4.3%
Others	9.2%
Cash	1.9%

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