JN Asia Infrastructure Fund

Newsletter Sep 2021 Quarter

Dear Investor,

This is the Sep 2021, quarterly newsletter of JN Asia Infrastructure Fund ("the Fund" or "JNAIF").

Last three months have been a good reflection of the core characteristic of our fund - **resilience and alpha generation in an unstable market**, despite being an unhedged long only equity fund. Between June to August'21, Asian Diversified Equity Funds were down 7-9% while Global Infra Funds were flat to up 1%. Meanwhile, JNAIF delivered a solid 3% return with consistent monthly performance. Macro issues like inflation, tapering growth, COVID resurgence are impacting investors' sentiment complied with the regulatory concerns in China are taking the wind out of easy returns made in Asia Pacific region.

JNAIF navigated these concerns well by focusing on businesses that have secular growth and non-cyclical cash flows underpinned by quality, scarcity premium and moats. JNAIF's four years of track record also reflects the same, top quartile performance with lower volatility and lower correlation to equity market.

In this quarterly, we try to decipher China's policy risks and how to navigate them while retaining our core belief of investing companies with strong moats, secular cash flows, that are trading at reasonable multiples.

What are your thoughts on the Chinese policy and regulatory environment?

In stock market, the windshield, in retrospect always looks very clear. However, rarely we see the future that clear.

Nevertheless, we believe, China market does provide that rare opportunity to understand the policy risks well in advance even though the country is governed under single party rule. Understanding the policy landscape is critical to investing in China and, most of the time, the President, the communist party and State Council (all powerful policy making body) lay out the ground work for the forthcoming changes in policies well in advance, for nuanced to take notice.

Consequently, in March'2021, when the Communist Party of China (CPC) in their annual policy meeting, laid out the "**Common prosperity**" as their central agenda, the writing was very clear that the government would make every attempt to work towards redistribution of wealth. **Reducing wealth inequality** is a key part of this agenda. Beyond equality, the government's agenda also include an **inclusive development model** and an **equal opportunity society**, which also ensures social mobility.

In this context, the **monopolistic platform companies** under the garb of "innovation", created enormous entry barriers for new companies/ new technologies to nurture. Meanwhile, continued to amass enormous wealth benefiting from their ever-expanding market power. These were the low hanging fruits for the Chinese Government to target. Secondly, cost of living has been skyrocketing with prices of three basic necessities – **housing, healthcare and education** getting unaffordable, key elements to the wealth gap. Making these three sectors the next target for regulatory intervention.

Going forward, we believe wealth redistribution could be achieved through – **primary distribution** by raising share of labour income at the cost of capital or lower business returns and **secondary distribution** by appropriate taxation, fiscal transfers and redirecting subsides (increasing or reducing across sectors). **In this context, we wrote in March'21 Fact Sheet:**

*"We see two additional risk factors in the horizon, one of which the market is **NOT** factoring in and another one, the market **CANNOT** factor-in. The first one comes from the recently concluded bi-annual meeting of Chinese Communist party, where they laid out 14th five-year plan, and aim to bring **"common prosperity'** in the society. We believe this theme which effectively aims for **wealth redistribution**, could be as powerful theme as "**Dual Circulation**" of last year. Under this, a focus area is likely to be the poor status of last mile delivery workers in gigs-economy. This section of working population is under tremendous pressure from long working hours, under-payment while catering to ever increasing consumers' need to deliver everything at their doorstep, which the ecommerce cos. are happy to meet. It's worthwhile to remember that in 2010, when the Chinese government started implementing "**social security**" to low-paid factory workers in Guangdong province and similar export driven centres in Southern China, the profitability of Chinese manufacturers took substantial beating in subsequent years. We believe adoption of **'employment status'** on these last mile workers and implementation of **social security** could bring a sea change in profitability of ecommerce and associated logistics companies. This potentially could be a much larger risk factor for the Internet companies than even the anti-trust policy that is currently being formulated by the Chinese government."*

*We further noted that in China, **more than 50% of population between 12-18 years suffer of myopia**, a shockingly high statistics, which makes eyecare a very profitable industry, but reflects – a) a high level of education related stress among school going children and b) exorbitant amount of time they are spending on electronic gadgets.*

What happened subsequently is now history. Unlike most of the market participants, for us, the current set of regulatory moves are **not new and neither these are one-off events**. These policy shocks led to double digit drawdown in China stock market every third year, which coincided many times with exogenous factors.

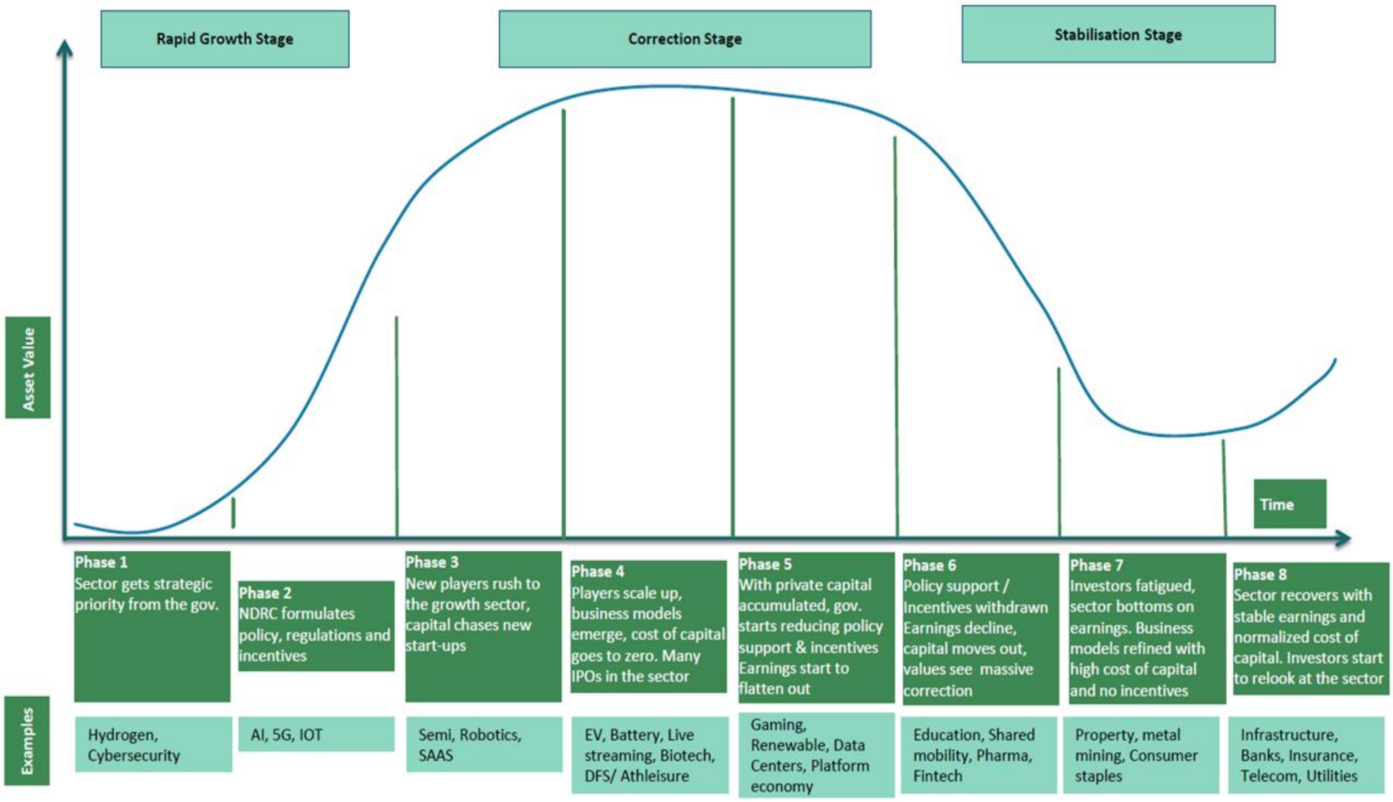
Over the last two decades, the Chinese government policy has aimed to normalise supernormal profitability and monopolistic profiteering by corporate irrespective of sectors or their market dominance. This is a unique blend of Western capitalism and Chinese socialism which many investors overlook. One may assign multiple theories to the current regulatory interventions, but the pattern is same, where a sector of strategic importance is initially nurtured and allowed to prosper to the extent that "cost of capital becomes zero". Then slowly the incentives start receding followed with multitude of regulatory intervention to smoothen out the extra-ordinary return in that sector. We have seen this in telecom in 2005, Banks in 2011, Properties, in 2013, Consumer in 2015, Tech/ Pharma in 2018 and now Internet/ Education in 2021.

E.g., China Mobile (the then largest market cap. company in China) was forced to develop TD-SCDMA technology in 2007-8 as an alternative to 3G/WCDMA, with a disastrous financial consequence. It was also asked to invest in Shanghai Pudong Bank. PetroChina, Sinopec were pushed to buy expensive oil assets overseas at peak of oil price. Such national service has been common throughout the past two decades and will continue.

We do not believe any of these policy measures makes China un-investable. This has been a regular approach of Chinese policy cycle in past two decades, where the government curbed monopolistic practices and normalises supernormal profitability across the sectors.

The following chart is our reflection of where the various sectors stand vis-à-vis regulatory risks.

Chart 1: China's policy risk cycle



Source: JNAIF

To us, the beginning of the de-rating phase for Chinese Internet names started in early Nov'20, when the Chinese govt. stopped Ant Financials from raising US$ 35bn in ADR market. Making clear that the government would deploy every tool in their arsenals to curb ever growing market abusing power of these platform companies.

Further to this, in order to reduce inequality in access to education sector, the government stopped after-school tuition services for core subjects and directed the existing ones to become non-profit organisations. In order to reduce financial risks in the system, the government clamped down on fintech lending, unauthorised lending activities to households.

In real estate sector, the government wants to create more social housing and rental system to make living more affordable in big cities. And reduce rising house prices but cutting leverage to the sector even if it comes at the expense of the largest players going bankrupt.

Cyber security is being tightened with online data ownership a contentious issue and the government wants to stop monopolistic practices related to data usage.

Lastly, in order to create a more level playing field between gig-workers and platform monopolies, the government wants to create a socioeconomic safety net for the large population of delivery personnel across sectors, primarily impacting ecommerce and logistics companies.

What is the likely outcome of the current Chinese policy and regulatory environment?

We need to understand Chinese policy response from the point of view key strategic objectives that the government is working towards. And, then deliberate the planned initiatives or policy response and its impact on achieving those critical goals:

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1) **Social welfare economy or common prosperity**: Chinese President Xi Jinping's formal goals are to make China "moderately developed country" in terms of per capita GDP terms by 2035, and, doubling GDP/capita by 2049 building China into a "great modern socialist country" marking the 100th anniversary of its founding. To achieve this goal the government has created certain policy responses.
   A. Government efforts to reduce wealth inequality by reducing cost of **housing, healthcare, education** and improving well-being of delivery works in internet economy. Inequality also feeds into the falling birth rate. For the govt. social stability matters more than a lop-sided economic growth.

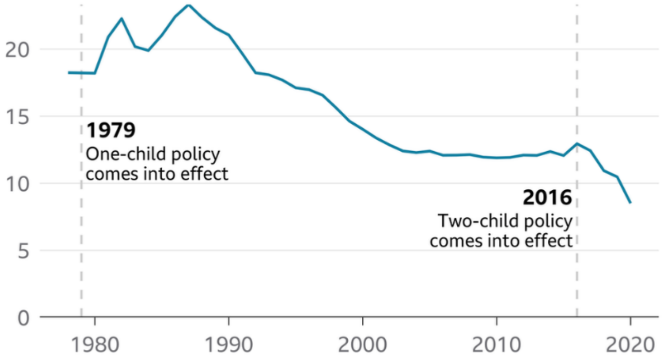
Chart 2: China's Gini coefficient suggests high inequality

Source: National Bureau of Statistics

   B. Work through the **demographic trap** and delay as much possible the increasing share of aging population. China's One-Child policy, introduced in 1979 was abandoned very late in 2015. This has led to a massive burden of ageing population with share of older than 60years doubling to 20% in last 30 years and then again doubling to 40% in next 30 years.

Chart 3: China's birth rate has continued to decline

Total number of births in China per 1,000 people (1978-2020)

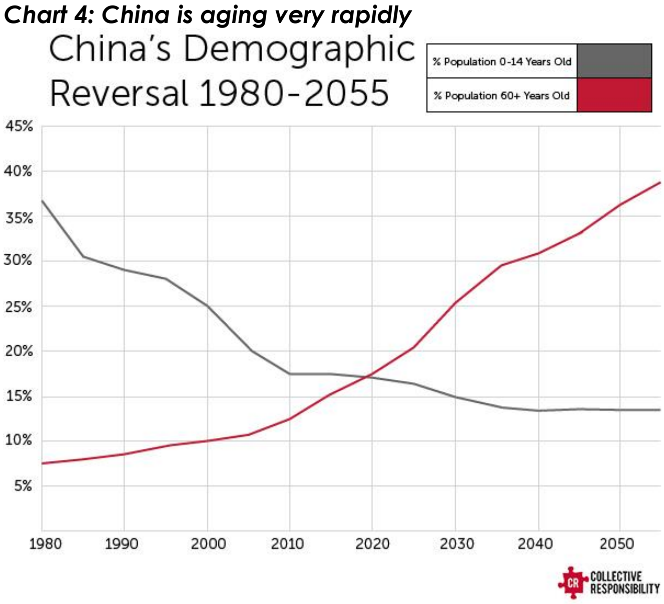


Source: China Statistical Yearbook

BBC

Reduction in the wealth gap and dropping the cost of living could help delay the demographic cliff that China faces.

Chart 4: China is aging very rapidly

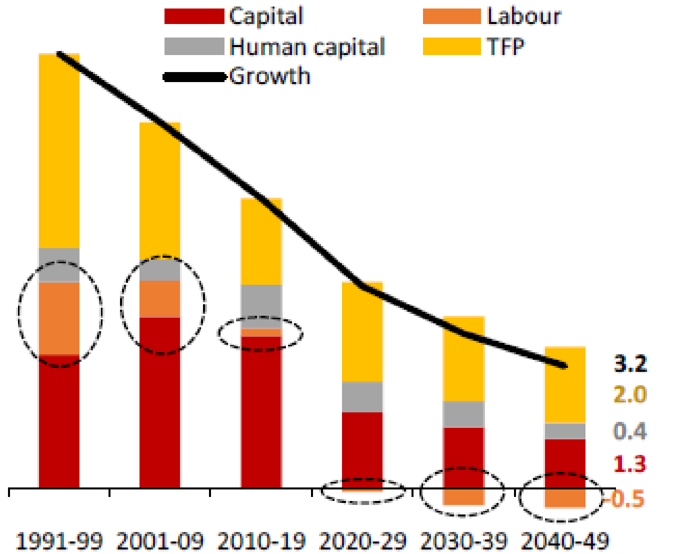


Source: Collective Responsibility

2) **Reduce risk of instability from economic shocks or from deteriorating US China relations;** meanwhile continue to increase China's relevance at the global pedestal.
   A. Take **strategic control of consumers' data** and prevent misuse of them by the internet platform monopolies.

- **B.** Discourage Chinese companies from ADR listing and eventually **reduce dependence on the US capital markets**
- C. **Reduce the financial risks,** curb shadow lending and prevent unbridled growth in online lending. China's property sector contributes 16% to GDP and 44% to overall govt revenues, yet government has drastically cut leverage to the sector.
- D. **Reduce the technology gap. Focus on core innovation in key sectors to improve productivity.** As highlighted in the chart below this is key to keep economy growing in coming decades

Chart 5: China potential growth breakdown (%)



Source: NBS< Bloomberg

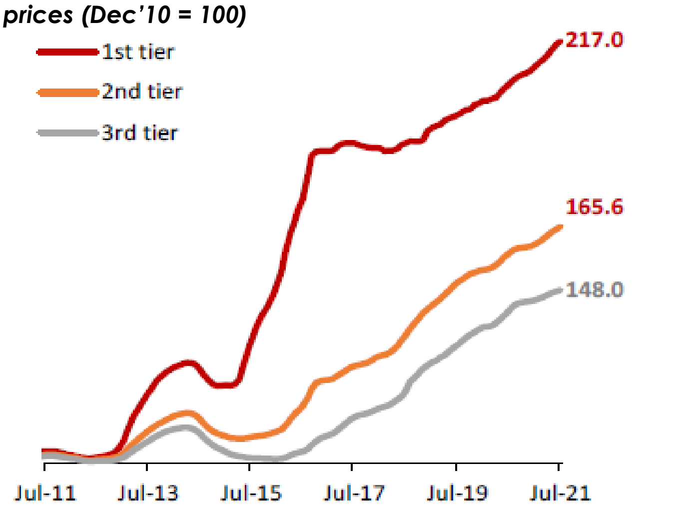
What are your thoughts on the investment implications given the Chinese political environment risk?

Chinese policy apparatus offers an equal number of opportunities and risks. As long-term investors we have tried to learn and gauge these trends – benefiting in segments that offer policy tailwinds and staying clear of sectors that have policy headwinds. However, if history is our guide, this kind of regulatory intervention eventually creates a **<u>structural de-rating of the targeted sector(s)</u>** and those sectors over a period of time they become less relevant in the market. In past two decades, some of the prominent sectors, have faced similar fates like - Telecom, Banks, Properties, Infrastructure and Consumer staples.

Keeping this in mind, we would like to avoid the segments, which are in the way of a) wealth redistribution, b) reduction of cost of living – housing, health, education, c) increasing birth-rate by reducing children inequality and burden, d) strategic ownership of data. In addition to that we would also avoid traditional fiscal stimulus dependent sector like construction, metals/mining as indicated by structural slowdown in Infrastructure sector and deleveraging in the economy. This in turn should improve quality of economic growth, and reduce future shocks to the economy.

In summary, we believe, a combination of the government mandated an increase in cost of capital (read – ***policy risks***) along with slowdown in growth sector (a function of their size and market share), should lead to a permanent de-rating of these many well-held sectors.

Chart 7: 70 cities newly built commercial & residential prices (Dec'10 = 100)



Source: Wind, DBS

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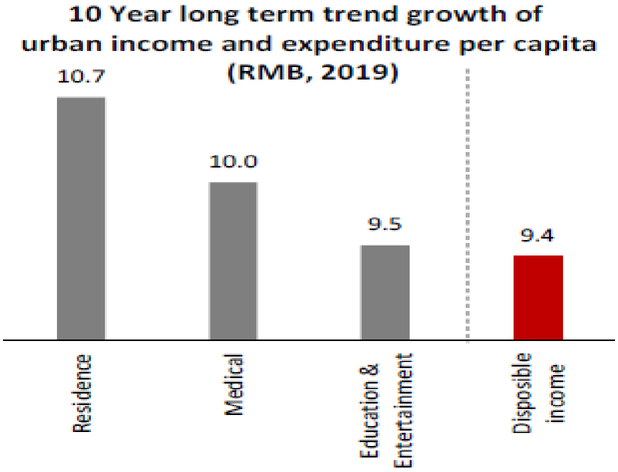
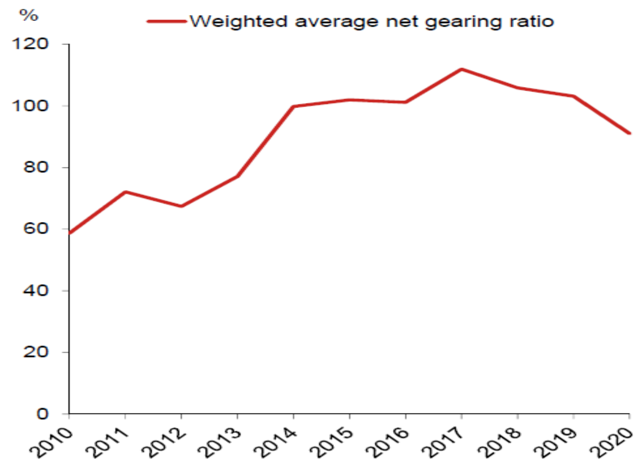
Chart 8: 10-year growth trend



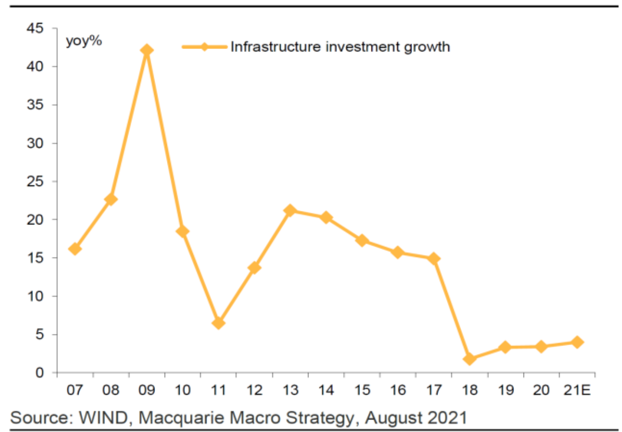
Source: CEIC, DBS

Chart 9: Lending to property sector coming down



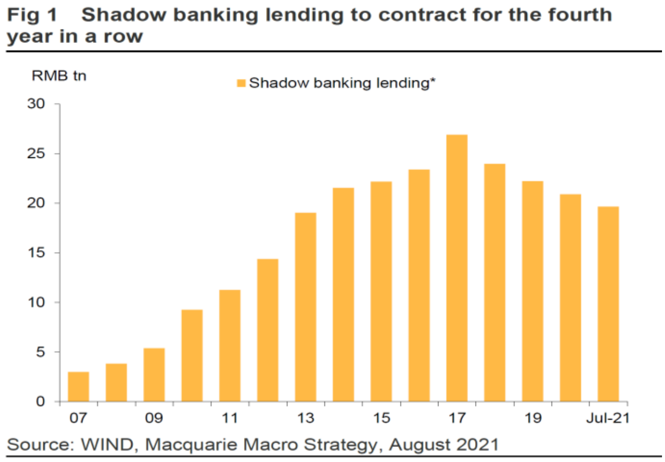
Source: Wind, Nomura

Chart 10: Infrastructure investment slowing down



Source: Wind, Macquarie

Chart 11: Shadow Banking slowing down



Source: Wind, Macquarie

At the same time, we would also be mindful of hot thematic sectors which the government wants to promote – Renewable, New energy vehicle or high-end manufacturing. We believe for these sectors; the cost capital has been brought down close to zero resulting in very high valuation and market expectation for growth. Traditionally these sectors neither enjoyed pricing power nor sustained moat. With a large number of new participants with strong capital backing away it will eventually make the future return from these sectors, very low.

Our portfolio exposure (Airports, Toll roads, Gas distribution, higher education) is on the **right side of the China policy curve**.

- these sectors have been listed space for a long period, and don't earn super normal profit or exorbitant return.
- despite having monopolistic market position, the pricing is regulated or moderated by the government
- because these businesses fulfil essential needs, the growth rate is GDP+ and noncyclical
- highly cash generative business and trade an attractive Op. cash multiple
- even Data Centre, the new growth area, is a **utility business**, providing physical infrastructure to HPCs and enterprises, supported by long term volume and pricing contracts.

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JNAIF portfolio snapshot at end of August 2021

Country Allocation	Portfolio %
China	20.6%
Australia	20.1%
India	12.1%
Singapore	11.0%
New Zealand	10.1%
Hong Kong	8.6%
Taiwan	3.9%
Thailand	3.6%
Indonesia	3.4%
Malaysia	2.6%
Philippines	1.9%
Cash	2.0%
Emerging Markets	**48.2%**
Developed Markets	**49.8%**

Sector Allocation	Portfolio %
Health Care Facilities	14.7%
Industrial Real Estate & Warehouse	13.8%
Airport Services	12.2%
Gas Utilities	10.9%
Highways & Railtracks	10.1%
Digital Infrastructure	9.4%
Air Freight & Logistics	8.2%
Waste Management	7.1%
Telecom Services	3.4%
Education Services	3.1%
Renewables	2.3%
Others	1.8%
Cash	2.0%

Disclosures

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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

Calendar Returns	2017*	2018	2019	2020	2021^	Annualized
JNAIF Return	2.66%	-0.88%	19.88%	7.04%	11.43%	10.28%
MSCI Asia Pacific Ex-Japan Index	1.59%	-16.25%	15.85%	19.80%	0.48%	4.56%
MSCI World Infra Index	1.10%	-8.11%	17.77%	-2.71%	4.75%	2.88%

*2017part year from 8th November 2017 (Inception Date)
^ Till 31st August 2021

Nuvest Capital