# Prusik Asia Fund Plc

FSA Authorised
Recognised Schedule 5

# Prusik Investment Management LLP

***An Independent Asian specialist investment manager***

**NAV Updates**

| *Series* | *May '07* | *MTD* | *YTD* |
|---|---|---|---|
| Class A | 164.04 | +3.58% | 12.50% |
| Class B | 164.04 | +3.58% | 12.50% |
| Class C GBP | 88.47 | +3.66% | 12.50% |

Fund Size $328m

| **NAV Update** | **May 2007** |
|---|---|
| Class A USD | |
| Non distributing | USD164.04 |
| Class B USD | |
| Distributing* | USD164.04 |
| Class C GBP | |
| Distributing* | GBP 88.47 |

In May the fund rose 3.58%. The month was characterised, in many sectors, by the emergence of bottlenecks and shortages, the result of strong demand. This was particularly the case in the infrastructure, coal, shipping, rail and food sectors. In some cases, such as at the Port of Newcastle in Australia, the infrastructure shortfall and the weather combined to generate near paralysis.

The resulting impact of this expansion in overall demand has lead to a sense that many segments of the global economy are under increasing strain and this perception has rippled across stock markets. In the words of one company executive we met: 'the markets are in a state where very little things seem to make a huge difference'. He was referring to the shipping sector. However, stock markets seem to be equally sensitive. Positively, such trends are, currently, largely generating upside surprises.

In many areas, valuations have now departed from traditional norms, in particular amongst some of the China consumption companies, some infrastructure providers and some of the 'heavy' industrials and shipbuilders in Korea. This has lead to a degree of frustration for us as we had happily sold some existing holdings on grounds of excessive valuation only to see further upside. Given current excesses, it is possible that a correction could generate significant downside for some of the more stretched share prices. However, in the shorter term, the continued strong demand supports our themes, underpins the high levels of growth forecast at the company level and sustains, to some degree, higher share price valuations. However, we continue to be vigilant to ensure that our assumptions remain realistic.

**Coal**

When China changes from being a net exporter to a net importer of a material or product, the immediate and longer term global impact on the price of that material or product is profound. We believe that we are about to see such an effect on the grain price, having already had a preview of this in 2004 when grain prices rose dramatically. Another product area where China also faces an increasingly formidable supply challenge is coal.

China's domestic coal supply rose only 6% between January and April 2007. Exports declined 29%, imports rose 50% and, as a result, the discount between the domestic and regional coal prices has narrowed to almost nothing. Such a trend is a strong sign of shortage. The strong PRC economy has driven demand for power upwards by 14% YoY in the first four months of the year. Due to the combination of new coal power plants coming on stream and an 8% decline in power generated from hydro-electric facilities due to dry weather, the demand for thermal power has risen even faster. Thermal power is now supplying 89% of China's power needs.

China is facing a number of other issues which could propel the coal price higher over the summer and possibly beyond. Net domestic fixed asset expenditure on coal has fallen this year. While new mines will add another 18% to total output, which sounds large enough to meet demand growth, the PRC Authorities have also been trying to close down the smaller, more unsafe and more environmentally damaging mines. The capacity of such mines is about twice the scale of the new capacity coming on stream this year.

Typically, China builds inventory at the beginning of the year to cover summer demand. However, even if production is sufficient, a lack of infrastructure and shipping capacity will still create bottlenecks. First, China's domestically produced coal needs to be transported along the coast to where it is needed. Only China flagged carriers are allowed to ply these internal routes and do so at shipping rates which are about 35% below international rates. China owns less than 4% of global bulk shipping capacity and needs to grow its fleet by around 20% per annum to meet demand. Given the global shortage of bulk carriers and resulting record freight rates, capacity expansion will not be achieved quickly enough to resolve this summer's problems. Second, while internal railway capacity has been rising, port throughput capacity is lagging by around 40%. Third, inventories are 15% below last year's levels. Put together, this means that replenishment after the summer peak could keep coal prices unseasonably high.

The first indicator of stress came in mid May when coal contracts for export to Japan expired and were then renewed at a price 28% higher YoY. At this time, extreme congestion at the major coal port of Newcastle in Australia was tying up some 8% of global bulk shipping capacity. The situation was made worse by a huge storm which stopped proceedings for several days. At the time of writing some weeks later, in spite of the local authorities attempts to ease the situation, there are still 66 ships queuing at Newcastle. Weather forecasts predict further bad weather.

Our conclusion from this is that coal prices are likely to be high across the region for much of the rest of the year driven by demand from China. We are also well aware there is much in this story which illustrates points we have made in previous months, namely that infrastructure spending will remain very strong, the example here being that port facilities in both China and Australia are unable to cope with throughput demand.

Given that the Pacific coal price is up 17% since the start of May, there is already speculation that the Korean power companies are looking to acquire Australian coal assets. Initially, we think that investors will value coal mines on net present values. However, once the acquisition trend gathers momentum, we believe that coal mines could be valued on an enterprise value to reserves basis. We are comfortable that all three of our coal investments, Yanzhou, Shenhua & China Coal are still, in spite of a sharp run recently, trading well below their NPV estimates which are based on coal prices assumptions below the current spot rate. If we use an extraction cost of US$25 per tonne, Yanzhou and China Coal are both trading 50% below the estimated value of their "proven" reserves.

**Whole Foods**

Even though we have been writing about food price increases for over a year now, the speed and size of some of the recent moves has still been shocking. As an example, based on the CPI announcement made last week, China experienced food inflation of 8.3% in May. This included a rise of 27% in meat prices and a rise of 33% for eggs. This is important as food comprises about 22% of household spending in China compared with less than 10% in the UK. Internationally, milk prices are up 60%, butter prices up 40% and grain prices up another 20% in the past few weeks. Even in agriculturally rich Thailand, which we visited recently, pineapple prices have risen 67% over the last 18 months. Finally, the international price of fishmeal, a staple ingredient of many animal feeds, has doubled so far this year.

Commentators remain remarkably relaxed and economists deny that it is any cause for concern on inflation. However, for a glimpse into the future we urge you to visit the new 'Whole Foods' store on Kensington High Street. This is not to admire the truly awesome array of food choices (apricot kernel butter and ostrich eggs, anyone?) but instead to gain a sense of what food price inflation really feels like. Maybe we are the only ones left in Richistan, sorry, Central London, to think that paying £7.20 for a pint carton of mixed fresh berries ( normal ones and in season!) or £3.50 for a small bag of salad ( ditto!) is excessive but we feel sure the overheard 'We're all going to be bankrupt' wasn't just an echo.

On a more serious note, there are several factors at work here which is why we cannot afford to remain too relaxed. Some are better understood than others.

**Ethanol**

The first factor, which we will discuss in brief, as it is well documented already, is ethanol. We think that this is a distraction because, ultimately, food supply will come before green fuel. We would be willing to bet that a large amount of ethanol capacity currently being built worldwide will be mothballed in a matter of years if not months. In the short term, however, the Americans are building ethanol capacity. If all the distilleries now being built in the US are put into production, nearly 30% of next year's grain harvest could go towards producing fuel for cars. This looms large for the world economy as the US corn crop accounts for nearly 40% of the global harvest and 70% of the world's corn imports. While corn is not yet directly a large proportion of diets in populous countries like India and China, indirectly it goes into milk, cheese, chicken, ham, beef, ice cream, and yogurt, all of which are. In short, there may be an insatiable demand for fuel but the grain required to fill a 25 gallon tank with bio-diesel would feed one person for a whole year. Even if the US utilised its entire grain harvest to produce ethanol, it would still only satisfy 16% of US auto fuel needs. However, this probably will not stop the US following its much vaunted green energy drive in the near future. If China conforms to our expectations and becomes a net importer of grain by the end of 2008, this will generate a nasty confluence of events.

The ethanol debate is a dangerous decoy because many regard it as the only reason grain prices are so strong and so it is therefore reversible. We beg to differ.

**Food Inventories**

The second factor is supply and demand which we have written about extensively before and so will just bring you a short update. The world continues to consume more than it is producing and yet the world population is set to increase by 50% by 2050. The world's inventory of grain is at a 35 year low at 57 days of consumption. Last time, inventories were this low, wheat and rice prices doubled. The European Commission no longer has reserves to help manage the market, having dismantled the meat, milk and butter mountains under the reform of the Common Agricultural Policy. Brussels will soon close its grain silos altogether. Over the last year, EU barley stocks have fallen from 2.2m tonnes to 0.1m tonnes, wheat stocks from 5.5m to 0.2m tonnes and maize stocks from 5.6m to 2.6m tonnes. As per capita incomes rise, food consumption changes towards a more protein oriented diet. We are seeing this in China where annual meat consumption is rising fast but is still only 6kg per person. This compares with 13kg of annual per capita consumption by its richer neighbours. As a rule of thumb. 10 kg animal feed is required to produce 1 kg of meat.

**Eating Fossil Fuels**

The third factor will concern you if you are a believer in the peak oil theory or that, for whatever reason, oil prices will rise further from here. We shall not embark on that debate here but simply point out a recent anomaly which sends a strong unintended message: namely that in recent months the Middle East, including Saudi Arabia has embarked on a vigorous programme of building a nuclear power system.

In developed countries like the US, fossil fuel use has increased 20 fold in four decades. Agriculture directly accounts for 17% of all energy used in the US and as of 1990 we were using about 1,000 litres of oil to produce food from 1 hectare of land. Apart from operating farm and food processing machinery, fossil fuels are the basic ingredients of fertilizer, natural gas is the feedstock for urea, and pesticides as well as providing the energy used to drive irrigation. In 1994, Pimentel and Giampietro calculated that 10 kilocalories of exosomatic energy, i.e. not human, is needed to produce 1 kilo calorie of food for the US consumer. If you remove fossil fuels from the equation, the current daily diet would require 111 hours. i.e., three weeks of endosomatic or human labour to produce the amount of food eaten each day.

Globalisation of food has not reduced our reliance on fossil fuels. The distance travelled by food has increased by 50% over the last two decades. A Swedish study of food miles involved in the typical Swedish breakfast, apple, bread, cheese, coffee, cream, orange juice and sugar, found that the combined mileage for the whole meal was equivalent to the circumference of the earth!

Without wanting to over dramatise the

situation, the best example of what happens to agriculture without oil is the fate of North Korea in the 1990s after the collapse of the Soviet Union which was the main exporter of oil to the Democratic People's Republic of Korea and supplied 90% of its needs. Petroleum consumption and agricultural production correlate very closely in all economies. We recommend looking up Richard Duncan's Olduvai Theory on Energy, Population and Industrial Civilization for more on this. However, we warn you that his findings are gloomy and forecast to be imminent.

**Tipping point**

The final factor is one of timing and anecdotal evidence from our recent trip to Thailand to explore the Thai agricultural sector and understand better what is happening within the food chain. Our findings were frustrating as, although food prices are expected to rise, even in Thailand, it is hard to find companies who will really benefit. For example, there are plenty of chickens in Thailand but the cost of raising them is growing as the corn prices rises. Margins for all producers are therefore wafer thin and falling. Meetings with the big hypermarkets suggested that retailers are refusing to accept any price increases from suppliers, who are suffering in largish numbers, but that the number of suppliers requesting price increases is rising rapidly. This was a blanket comment across all products not just food. We seem therefore to be at a point either where prices go up or where suppliers consolidate and, as a result, prices go up. We are not about to buy shares in a debt laden chicken farm in Thailand with 1-2% margins but on the other hand we would be a buyer of chicken prices over the coming years.

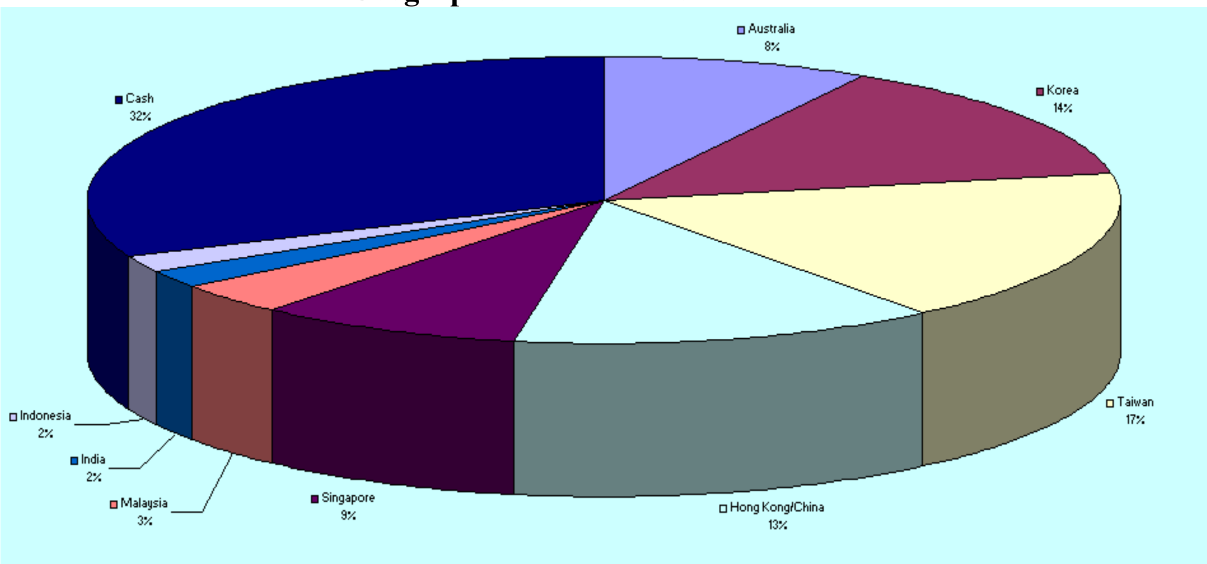
More interestingly, China Milk, listed in Singapore, appears to be a direct beneficiary of rising milk prices. It is the largest cattle husbandry company in China operating nine farms with a herd size of around 14,000 cattle. Its sales are driven by the production of bull semen, 78% of sales, embryos, 8% of sales and raw milk, 14% of sales. The latter should rise as a proportion of sales once the company embarks on OEM raw milk production. It is therefore, unlike the dairy companies, a indirect and direct beneficiary of rising demand for and prices of dairy products. Trading on only 9.5x FY03/09E and a FY3/09E P/BV of only 1.6x in spite of a 24.2% ROE, it also looks modestly valued.

The overall portfolio has risen to 14x 2008 earnings with over 20% earnings growth forecast for that year. Return on equity is still above 20%.

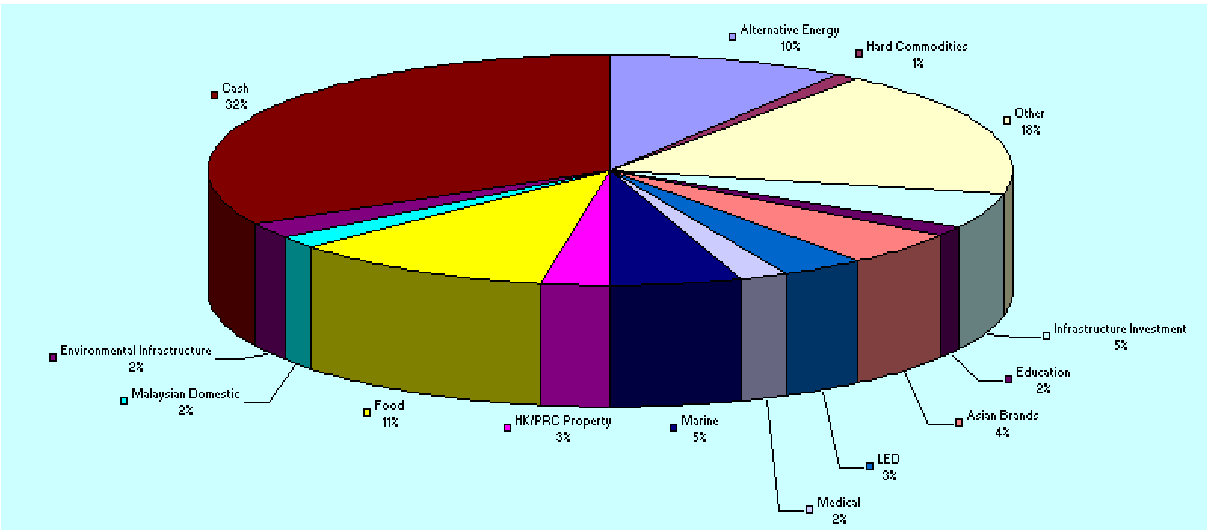
| Top 5 Holdings | % |
|---|---|
| FORMOSA PLASTICS CORP | 3.7% |
| STX ENGINE CO LTD | 3.2% |
| TAIWAN FERTILIZER CO LTD | 3.1% |
| ALPHA NETWORKS INC | 2.4% |
| KOREA COTTRELL CO LTD | 2.2% |

| | |
|---|---|
| Number of holdings | 48 |
| Percentage of Fund invested | 68% |

## Geographical Distribution




## Distribution by Theme




| Year | Jan | Feb | Mar | Apr | May | Jun | Jul | Aug | Sep | Oct | Nov | Dec |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| 2005 | | | | | | | | | | -1.90 | 5.64 | 5.08 |
| 2006 | 7.71 | 0.09 | 1.84 | 10.14 | -1.95 | -0.45 | -1.72 | 0.02 | 1.23 | 3.90 | 7.64 | 1.97 |
| 2007 | -0.01 | 1.28 | 3.05 | 4.08 | 3.58 | | | | | | | |

Key Parties to Fund

| | |
|---|---|
| Investment Manager | Prusik Investment Management LLP |
| Administrator | Bisys Fund Services (Dublin) |
| Custodian | Brown Brothers Harriman (Dublin) |
| Auditor | Ernst & Young |
| Legal Advisors | Dillon Eustace (Dublin) |
| | Simmons & Simmons (London) |

Key Terms

| | |
|---|---|
| Denomination | USD |
| Dealing Day | Weekly (Friday) |
| Minimum Subscription | USD100,000 |
| Min Subsequent Subscription | USD10,000 |
| Subscription Notice Period | 2 business days |
| Redemption Notice Period | 2 business days |
| Dividends | |
| Class A | None |
| Class B | Annual |
| Class C | Annual |

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Manager Fees

| | |
|---|---|
| Management Fee | 1.5% p.a. paid monthly in arrears. |
| Performance Fee | 10% of NAV appreciation. With a 6% hurdle. |