PRUSIK

GROWTH INVESTING IN ASIA

Prusik Asia Fund

Quarterly Investment Report
28 September 2018

FOR PROFESSIONAL INVESTORS ONLY

Prusik Asia Fund Quarterly Report Q3 2018

Performance Commentary

The fund saw a decline in the third quarter of 1.1% versus the index decline of 0.2%. Over the quarter, we saw a very solid double-digit return in our infrastructure/logistics/property theme, driven by the Chinese constructions stocks that we added in the second and third quarter. These stocks have recently seen strong support, likely facilitated by their rock bottom valuations – we bought the stocks on just 5-6x P/E – coupled with new infrastructure project announcements by the Chinese government. It is worth noting that these purchases were partly funded by our sale of **Tencent**, and other internet names (see below). From the end of April, when we sold **Tencent** and recycled the capital into **China Railway Group**, to the time of writing, **Tencent** has fallen by 27.4%, whilst **China Railway Group** has risen by 21.3%. Overall, the fund's lack of exposure to Chinese internet stocks also had a positive impact in the third quarter.

We also saw good absolute and relative returns in our energy/energy services theme, as the rising oil price led our Chinese oil stocks higher, as well as good absolute returns in our artificial intelligence/virtual reality and healthcare themes. After the excellent performance from our education theme in the second quarter, much of this was given back in the third quarter as proposed regulatory changes spurred an indiscriminate sell-off in the sector. We have analysed the potential impact of these regulatory changes on **China Xinhua** and subsequently, are of the view that the impact on **China Xinhua** is likely to be limited and the share price reaction has been overdone.

Our financialisation theme was also negatively impacted in the quarter. India saw a short-term credit freeze in September in reaction to IL&FS, a large-scale infrastructure operator and financier in India, defaulting on one of its bonds with no pre-warning from the credit agencies and despite having a AAA rating. This caused concerns that the 'Non-Bank Financial Companies' (NBFCs) in India, including mortgage finance company, **Indiabulls Housing Finance**, which rely on short-term funding could face problems with refinancing, compressed margins or slower growth or even a combination of all three. We will discuss this topic in more detail later.

At the stock level, **Fila Korea** had another stellar quarter, returning 34.1%. We were also pleased to see the previous correction in **Phu Nhuan Jewelry** reverse during the period. Similarly, **Beijing Capital Airport**, which had sold-off in response to the cancellation of its Airport Construction Fee saw a recovery in the quarter with a return of 19.7%.

By country, we saw double-digit positive returns from our exposures in Taiwan and South Korea. India continued to be a drag on performance in the third quarter with currency weakness being a key contributor here. China/Hong Kong also detracted from performance as the gyrations of the US-China trade war continued to play out.

We have set out more details on the above in the tables and commentary below.

3Q18 Return on Capital by Theme

Theme	PAF Return on Capital 3Q18
Infrastructure/Logistics/Property	10.0%
Energy/ Energy Services	5.1%
Healthcare	4.1%
Artificial Intelligence / Virtual Reality	2.3%
Vietnam	2.2%
Leisure/Tourism	-1.2%
Local Brands	-2.3%
Financials	-6.4%
Education	-31.4%

Source: Prusik/Bloomberg

3Q18 Absolute Attribution by Theme

Theme	PAF Absolute Attribution 3Q18
Infrastructure/Logistics/Property	1.46%
Energy/Energy Services	0.69%
Healthcare	0.22%
Artificial Intelligence / Virtual Reality	0.17%
Vietnam	-0.07%
Leisure/Tourism	-0.22%
Financials	-0.67%
Local Brands	-0.84%
Education	-0.90%

Source: Prusik/Bloomberg

Outperforming Themes in 3Q18

Infrastructure/Logistics/Property: 19.6% average weighting in 3Q18

- The infrastructure/logistics/property theme returned 10.0% in 3Q18, led by our Chinese construction companies.
- In response to the trade war, China launched a number of new infrastructure projects to help stimulate the economy.
- Our Chinese construction stocks had been trading on just 5-6x P/E when purchased leaving scope for a re-rating.

Energy/Energy Services/Resources: 15.5% average weighting in 3Q18

- The energy/energy services theme saw a 5.1% return in 3Q18, led by **CNOOC**, China's leading integrated oil and gas company.
- In 3Q18, the oil price rose 4.1% to over US$80 / barrel in response to greater than expected tightness in supply.
- **PetroChina** also performed strongly in the quarter, buoyed by its announcement of a special dividend.

Healthcare: 10.4% average weighting in 3Q18

- The healthcare theme saw a 4.1% return in 3Q18, led by leading Indian generics manufacturer, **Sun Pharma**.
- **Sun Pharma** announced better than expected results in the quarter, helped by monetisation of its US specialty pipeline.
- **AK Medical**, our Chinese orthopaedics company with capabilities in 3D printing continued to perform well in 3Q18.

Underperforming Themes in 3Q18

Education: 2.5% average weighting in 3Q18

- Our education theme saw a negative return on capital in the quarter.
- Draft regulatory changes were announced by the Chinese government for the private education sector with potential negative changes regarding tax, M&A and government grants.
- We believe the share price reaction to the news was excessive and the likely impact on **China Xinhua** is limited.

Local Brands: 12.8% average weighting in 3Q18

- Our local brands theme saw a negative return on capital in 3Q18, led by our Chinese home appliance brands.
- The Chinese home appliance brands reported slower growth in the quarter owing to a softer macro environment.
- Our Korean sportswear brand, **Fila Korea**, saw another quarter of stellar performance.

Financialisation: 11.6% average weighting in 3Q18

- Our financialisation theme saw a negative return on capital in 3Q18, led by Indian housing finance company, **Indiabulls Housing Finance.**
- Unlisted infrastructure operator and financier, IL&FS, defaulted on one of its bonds causing a sharp decrease in liquidity in India, in turn causing a market panic for the 'Non-Bank Financial Companies' in India, which rely on short term funds.
- Indonesian bank, **Bank Mandiri**, was sold during the quarter owing to concerns regarding the macro in Indonesia.

Outlook

In summary, the valuations in Asia are now looking very attractive on a risk/reward basis. Moreover, we have already seen China start to introduce easing measures for the economy, including the recent reduction of the RRR. Whilst it may not be easy for Asia to initially outperform if the US equity market turns down, we would still say that the current level provides a very attractive entry point for anyone looking to increase exposure to Asia on a 3-year view.

Valuation

The global risk-reward of being invested in Asia is now beginning to look very attractive. At the time of writing after recent sharp falls, and as the chart below from Credit Suisse highlights, the Asia ex Japan (and *ex*-Internet) P/B has dropped to 1.24x—just 3% from the lows of 2016. While no two episodes are ever exactly alike, there are current similarities with 2016 e.g. Fed tightening, US dollar strength, a falling Renminbi and a weak Chinese economy. With some analysts suggesting the current environment (largely because of the trade wars) could be worse than 2016, we would also point out that the current P/B of 1.24x is now just 13% from the Global Financial Crisis (GFC) lows of 1.1x P/B.

Figure 1: Asia ex. Japan ex. Internet P/B

Source: Company data, Credit Suisse estimates

It is important to also note that the main Asia ex-Japan (MXAPJ) index (*inclusive* of internet) is trading on a P/B of 1.45x but over the last 30 years, has traded 96% of the time between 1.2x and 2.5x P/B, and has averaged 1.75x P/B. Given that ROE has averaged 12% over this time and there has never been a 3-year period where it has averaged under 5% then, even taking into account a worst-case scenario, the downside from here is not significant i.e. around -2%. If the outcome is to return to averages then the total return upside is 17%.

MXAPJ Index	479.51		
BOOK_VAL_PER_SH	330.28		
Current P/B	**1.45**		
		3 year expected annual returns	ROE assumption
Bear case (1.2x P/B, 5% ROE)	**1.2**	**-2%**	5%
Base case (1.75x P/B, 12% ROE)	**1.75**	**17%**	12%
Best case (2.5x P/B, 18% ROE)	**2.5**	**37%**	18%

We believe the key risk for the Asia ex Japan P/B overshooting the 2016 lows on the downside comes from US equity valuations where P/B is a lofty 3.27x

China

In recent days, the Shanghai Composite saw turnover fall to the lowest level since January 2016 and touch on index levels not seen since 2014. Here are some of the observations and thoughts on China after two weeks in Asia in September.

Conclusion: We think we will see the lows before Christmas or latest Chinese New Year and that next year could be very good for China.

Trade War

Firstly, and without exception, we believe that we are very unlikely to see a negotiated end to this trade war, at all, and certainly not any time soon under the current American leadership. We expect that we could continue to see aggressive action on both sides and that the imposition of tariffs by the US is actually not so much about trade but about stopping China in its overall economic progress which, with its economic size, is causing the US to feel threatened as a super power (i.e. technology supremacy and its place as the world's reserve currency). As a result, we are of the belief, to repeat the above, that we not expecting to see a happily settled trade dispute any time soon.

It is, however, not easy to agree what China will do, although we think it likely that China will potentially not negotiate much further and will instead accelerate its domestic reforms. China might need to put in place economy boosting measures as well by next year and will continue, if not accelerate, its BRI initiatives, which will provide plenty of new trading partners amongst EMs.

Nobody has yet seriously discussed if China might do to the US what they have recently done to Korea i.e. stop tourism/visas, guide consumers away from Korean brands and so forth. This is serious and our recent 3 days in Korea really highlighted how effective for China and negative for Korean businesses this has been. We think this remains quite a risk for US businesses operating in China and US brands selling in China. It might be very subtle, but the recent extraordinary success of domestic brand Luckin Coffee versus Starbucks shows how consumers can quickly move towards domestic brands. Any kind of subtle pressure would be the equivalent of pushing on an open door with consumers in certain sectors.

Private Sector

To anyone who has not been following the machinations of Beijing politics in recent months, this may seem a strange article to focus on. After all, China's growth over the past 3 decades has been driven by a massive mobilisation of the private sector in a capitalist frenzy.

The private sector accounts for 80% of employment, 60% of GDP and 50% of tax revenue in China. At the end of 2017, there were 65.79 million individually-owned businesses and 27.26 million private enterprises in China, which employed some 340 million people.

However, there have been multiple attacks on the private sector in recent months, from increased regulation on Tencent, Jack Ma's departure from Alibaba, tax collection changes in the education sector and several comments about 'ending private property ownership'. We have even seen writer, Wu Xiaoping, saying that 'the private sector has fulfilled its role and should step aside now' (a post that the South China Morning Post reported had swiftly been deleted).

A recent meeting of pro-reform liberal economists held in the State Guest House in Beijing, known as the '50 Forum' (its 20th anniversary conference), was widely covered in the Hong Kong media. Yi Gang (PBOC Governor) and Vice-Minister Liao Min were in the audience, and Vice-President Liu popped in too. Discussions at that forum were said to have underscored the frustrations at recent policy direction in China.

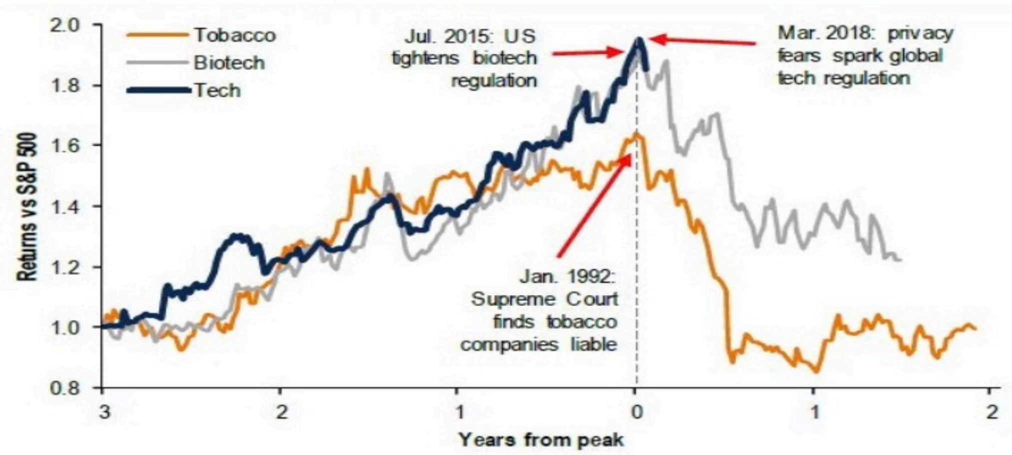
China has a powerful civil service but if there is uncertainty about direction, then they can be slow at implementing pro-reform policies. However, in a recent trip to a petrochemical factory President Xi reiterated his unequivocal support for both the private sector and SOEs. The fact that Xi has now spoken in support of the private sector may be key in unblocking things.

In summary, it seems that China will be forced to find engines of growth from its own region and country and the current reforms that have created poor sentiment in the stock market are deemed a necessary precursor to the next round of government measures which will likely restore confidence, liquidity and maybe some improved economic growth. We can expect the Chinese leadership to unleash these measures when they feel the timing is most opportune for creating a flow of money into the Chinese financial system. They will be patient but the relative performance versus the US has no doubt stretched almost far enough.

China Internet: Why We May Not Buy Back the Big Internet Companies

In our 1Q18 PAF quarterly, we outlined why we were reducing our exposure to the internet companies. It was a very concise set of reasons regarding the March introduction of GDPR rules in Europe, together with the following chart, which shows what happens to returns in a sector which has grown without a regulatory framework and then suddenly has one imposed.

Equity bubbles popped by regulation



Source: BofAML Global Investment Strategy

We argued that as European internet users become increasingly concerned about privacy and demanded their data back, the value of the data sets that the internet giants use for targeted advertising and the like would be reduced, due to incompleteness. This, in turn, should affect the valuation that the internet companies trade on, creating potential significant downside.

We also argued that whilst Europe was ahead of the curve on regulations that these data protection rules would eventually become global 'best practice' and we would see versions of this being introduced elsewhere in the world, which would have a similar impact. (By way of example, California has just passed a lighter version of GDPR, which will come into effect in January 2020. This was heavily opposed by the internet companies and was eventually rushed through and approved in great haste, whilst notably in the process, leaving no room for a similar but much tougher proposal, which was already gaining popular momentum.)

Ironically, it is in Asia where it was deemed the least likely for these kinds of rules to appear, not least, it was argued (and still is) that the governments and people in Asia, or at least China, are in some kind of mutually agreed pact around the loss of privacy and the pervasiveness of data collection in return for the efficiency of internet usage, and government's request for compliance. As a result, regulation, it was assumed, is not really likely to happen in Asia (and specifically not in China, where the internet giants and government seem to be hand in hand).

However, two quarters on and we have the Asian internet companies languishing well below the 1Q18 highs whilst the US giants are still flirting with new highs, albeit with a few cracks appearing in the edifice of Facebook. Tencent, as the bellwether Asian internet blue chip stock is, as we write this, trading precisely 33.3% below its February high. Moreover, 48 out of 49 analysts have it currently rated as a buy with just one hold recommendation. Our straw poll from recent attendance at a large conference in Asia was that most investors still own these companies (and any suggestion that active investors might not want to continue doing so is treated as heresy.)

So, after such a big correction are we tempted to revisit the internet companies and buy them back at such allegedly attractive levels? This is, at first glance, a difficult question to answer if you only read analyst research as ostensibly there is only one reason, so far, that we can see as to why these companies have corrected so sharply, and this has largely been dismissed by the number crunchers. However, in our view it's a very important development, namely that the Chinese government have issued new strict guidelines surrounding how long under age teenagers and kids can spend online playing games. More on this below.

At the recent CLSA forum in Hong Kong, whilst the internet analysts remain fervently bullish, the 'specialist' tracks produced 4 separate speakers who all, in one way or another, added to our concerns that the whole internet sector, globally, will face significant headwinds from here. These headwinds are as follows:

Privacy, Trust and the Value of Data

First of all, we have the issues which surround privacy, the value of user's data to the internet companies and the trade-off between the two. These are well rehearsed but are now gaining more widespread appreciation amongst users. If governments start to allow users to remove their data, will they? *We are told that the value of a user who refuses to allow data to be tracked is worth 60% less.*

Perhaps one of the growing areas of understanding by users is just how valuable their data is to the internet companies and the question from here could be to what extent users are prepared to continue to let this uneven contract remain. Perhaps they will demand payment for their data in some form, from money to additional services? We can certainly see new social media start-ups now forming with this at the forefront of their business policy.

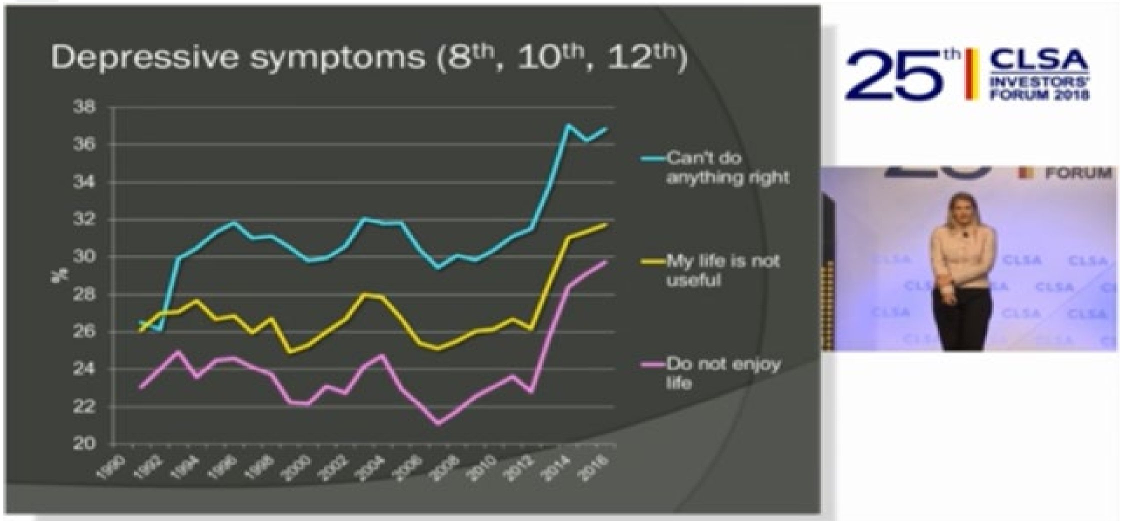
In any event, without internet companies becoming a lot more transparent and as users become a lot more aware, it is likely that soon users will run into a slew of issues regarding trust. At this point users will find, for example, that their insurance premiums have risen because of an algorithmic calculation, based on the users' data profile. Given that the internet companies claim they can already tell such intimate factors such as your current 'emotional temperature', how long before users become aware that they are being exploited or discriminated against in some way? The 'value' to the user of their presence on the internet may suddenly become scarred by their realization of the heavy imbalance – financial and otherwise - between their own benefits and those that are accruing to their service providers.

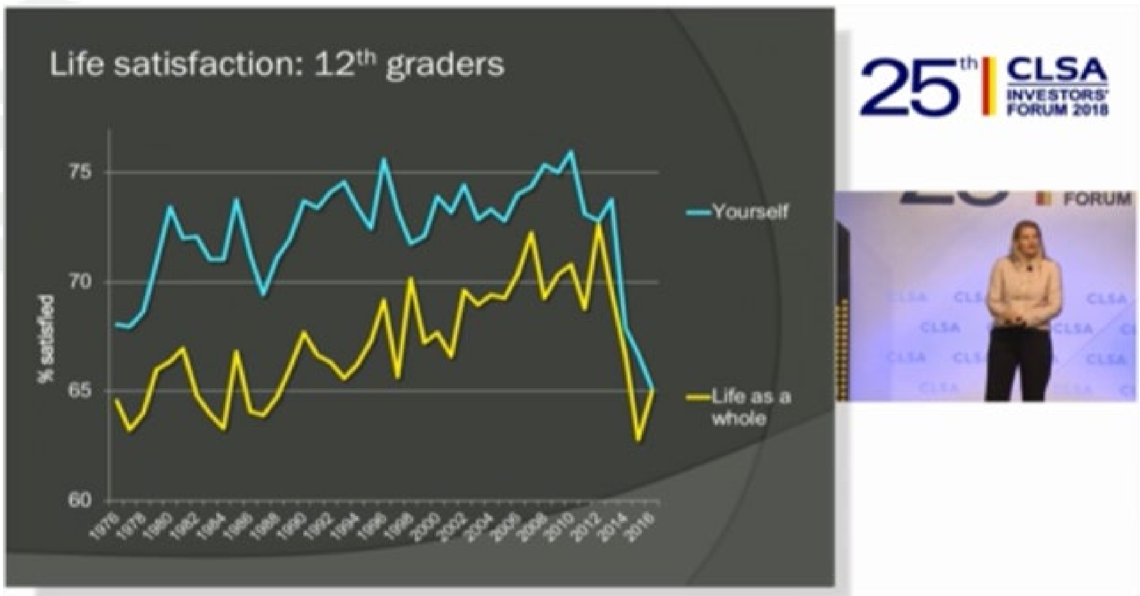
Health and the Internet

There is a crisis brewing amongst the Generation Z or 'iGen', namely those born after 1995. They are all still either at school or in college and in both cases, there is growing evidence that whilst they are the generation most unlikely to rebel and significantly less likely to indulge in 'adult' behaviour (drinking etc.) like their parents would have at the same age, they are actually suffering a mass breakdown in mental health. For example, self-harm amongst girls aged 10-14 years old has risen 6-fold since 2009. Shockingly, in this generation, the suicide rate has doubled in the past 10 years. Since 2011 any measure of happiness amongst this generation has fallen, whilst 'life satisfaction' has fallen off a cliff.

This data was presented by Jean Twenge at the CLSA forum, looking at depressive symptoms in 8th, 10th and 12th grade students in the USA. She has analysed data from huge studies going back to 1966, looking at the behaviours and happiness of young people.


What fits – and what doesn't
2
1.5
1
0.5
0
-0.5
-1
-1.5
-2
2006
2007
2008
2009
2010
2011
2012
2013
2014
2015
2016
Depression
Smartphone adoption
Time online
Unemployment
25th CLSA INVESTORS' FORUM 2018
FORUM


Depressive symptoms (8th, 10th, 12th)
38
36
34
32
30
28
26
24
22
20
%
1990
1992
1994
1996
1998
2000
2002
2004
2006
2008
2010
2012
2014
2016
Can't do anything right
My life is not useful
Do not enjoy life
25th CLSA INVESTORS' FORUM 2018
FORUM


Life satisfaction: 12th graders
75
70
65
60
% satisfied
1976
1978
1980
1982
1984
1986
1988
1990
1992
1994
1996
1998
2000
2002
2004
2006
2008
2010
2012
2014
2016
Yourself
Life as a whole
25th CLSA INVESTORS' FORUM 2018
FORUM

What is clear from the data is that something huge happened around 2011 which had a terrible effect on teenager and young adult mental health. The event with the closest fit to this rapid and shocking change was the arrival of the ubiquitous smartphone and social media.

Studies suggest that kids routinely spend between 6 and 8 hours a day on their phones, either playing games or on social media. This comes also at the expense of sleep and sports and actual socializing, all of which is having this negative and catastrophic effect on mental health.

The question is do the internet companies have any complicity in this? A risk to these businesses and for shareholders is this: Do the public have a potential class action case that the social media and gaming companies deliberately make their products more addictive, even knowing that this is capturing kids at huge cost to their wellbeing? Published in 2014 the book, 'Hooked – How to Build Habit Forming Products', gives us a glimpse into this way of thinking that internet companies have apparently adopted. And even if they haven't, can anyone actually spend more than 8 hours a day on their smartphone? It looks as though we are maxed out in terms of eyeball time.

The Chinese government is clearly beginning to understand these issues and is acting accordingly with its latest regulation on underage gaming and more recently TV programmes warning on the subject on the country's main TV channel. We believe we should expect more regulation at least. At worst, in years from now, social media, gaming, smartphones and their creators could be seen as the new smoking and tobacco companies.

Antitrust?

Today, Google and Facebook combined earn 85c from every $1 spent on advertising online. In the past, a million record sales would have generated $900,000 for a musician but a million streams on YouTube yields barely $900. There has been an 80% decline in what people are prepared to pay for newspapers. Amazon owns 75% of all book sales.

There has been some recent commentary that there may be a rising chance of cases of antitrust in the US although, staggeringly, the US has bought just 1 monopoly case since 2000! In the US, the companies actually have to be doing 'harm' before a case can be brought and as yet, it seems there is no coherent case for antitrust, albeit quite a few suggestions on how they can be causing 'harm'. These can include privacy issues, surveillance and security of data, wealth transfer to companies, overly high rents for small suppliers, 'kill zones' where apps which work against the interests of the big companies get stopped, political issues and so on. However, in Europe there is now serious antitrust scrutiny against Amazon. Also, there has also been a recent hiring of a young lawyer in Washington named Lina Khan who wrote a ground-breaking thesis on how the big internet companies might be breaking antitrust laws. It is still very early day but we, nevertheless, believe this is a story which is likely to be told.

Web 3.0

Web 3.0 will change everything you thought you knew about the internet.

In a recent webinar with Dr. Peter H. Diamandis, Gabriel Rene, Founder of VERSES Foundation, explored how artificial intelligence is now converging with blockchain, the IoT, and virtual/augmented reality to create the "Spatial Web," and the next phase of the global economy.

The first version of the Web was about a networked library of information accessed via a browser. The second wave of the internet—Web 2.0—disrupted "content" such as music, television, videos and photos. It also enabled sharing via social networking, blogs, wikis, video sharing platforms and data storage sites. Web 2.0 also heralded the mobile computing era, facilitating location-based and crowd-sourced sharing technologies that disrupted "physical" services, such as transportation (Uber), lodging (Airbnb) and labour (TaskRabbit).

Now, Web 3.0 is quickly being deployed, although much of it is not yet visible to the end user. However, the third wave of the internet will usher in a new multi-dimensional web, which will simultaneously be more physical, contextual, distributed and spatial. Think "the Oasis" in the movie *Ready Player One*, where users develop personas, conduct business and collect real estate and belongings in a completely-simulated world. According to Rene, "it will not merely disrupt our current products, services, and industries, it is set to disrupt reality itself."

For investors, firstly, Web 3.0 represents the next step towards a machine-driven economy that will foster new business models and disrupt incumbents**.** Second, a blockchain-based internet will enable users to regain ownership and control of their data—*ending the reign of the big tech data aggregators and profiteers*. Third, key enabling technology providers are set to outperform.

Web 3.0 will reinvent the internet as a peer-to-peer replacement for Web 2.0. Web 2.0 democratized many power structures and created new opportunities. However, users have traded their privacy in exchange for free services. In contrast to Web 2.0, where addresses can be associated with identities, Web 3.0 users are pseudonymous, only identifiable by their accounts.

AI, the IoT, and blockchain work in concert under Web 3.0. Virtual and augmented reality (VR/AR) are the interface. The IoT acts as a digital nervous system for feedback, enabling businesses to create customized product experiences. Blockchain consensus algorithms provide accountability and can manage decentralised systems.

Critical Web 3.0 advantages are that end users regain control and ownership of their data, they find improved security and reliability and there is increased inter-operability with no middlemen.

The shift to decentralized Web 3.0 has already begun and we expect that, as with previous disruptions, new business models will upend incumbents. For example, instead of cloud storage services like Google Drive or Dropbox, decentralized storage services like Storj, Siacoin, Filecoin, or IPFS technology distribute and store files across thousands of nodes, making hacking impossible**.** Rather than Skype or WhatsApp, platforms such as Experty.io and Status bypass third-party service operators and rely on peer-to-peer connections. New decentralized social media platforms such as Akasha and Steemit not only provide secure alternatives to Facebook they enable users to get paid for good content, as well as post and even upvote articles to receive a share of a daily rewards pool.

The current Web is built with protocols that assign addresses to web pages and there is no protocol for the transfer of physical objects or digital assets. However, the VERSES Foundation is developing the tools to turn any virtual or real-world space into a web space.

The VERSES protocol enables users to register virtual spaces, goods, and avatars, effectively bringing the Web into the third dimension. This will allow users to interact and collaborate with virtual objects or connected physical objects across platforms, devices, and location. The VERSES protocol will be compatible with over 2 billion connected mobile devices by 2020.

Could this be the equivalent of "1993" for Web 3.0? In 1993, there were 623 web sites. A year later there were 10,000. Today there are over a billion. It is still early days for Web 3.0 and many challenges remain for the underlying technologies to reach their full potential. However, Web 3.0 and the "Spatial Web" may be one of the next big investment opportunities, but also disruptions, of our time.

India NBFC Debt Default: Contagion?

Investment Conculsion

1) India's increasingly weak financial system will make foreign investors less confident about India's growth opportunity and may even slow down growth as credit drags.

2) Rising interest rates and bond yields will increase the cost of funds for the NBFCs, eroding margins further and making debt repayment even tougher. These stocks are expensive.

3) The liquidity crunch and payment defaults may slow credit growth further, impacting the nation's infrastructure investments and consumption.

4) Investors may avoid investing in India's financial companies, especially NBFCs, given their steep valuations and weakening fundamentals.

5) The risk of a full-blown financial crisis is still rising, despite government moves to dampen everything.

Current Situation

There have been rising non-performing loans among government-owned Indian banks. Private banks have also started showing signs of strain, and India's regulator is investigating certain banks for governance issues.

Now, the risk of debt default for NBFCs is mounting. IL&FS, India's foremost non-banking infrastructure financier with $12.5 billion in debt, has missed five-payment obligations since August 2018**,** making markets nervous and driving borrowing costs in credit markets.

NBFCs lack access to sticky household deposits, the Central Bank, and interbank liquidity options—underscoring that even small defaults could have extended ripple effects. The continuing increase in bad loans and the deteriorating debt-servicing ability at NBFCs have made India's entire financial ecosystem fragile.

In recent days short term interest rates have shot up, creating a freeze. The government used its "God mode" to dismiss the board of IL&FS and reconstituted it, with Uday Kotak as Non-Executive Chairman and other high-profile appointees.

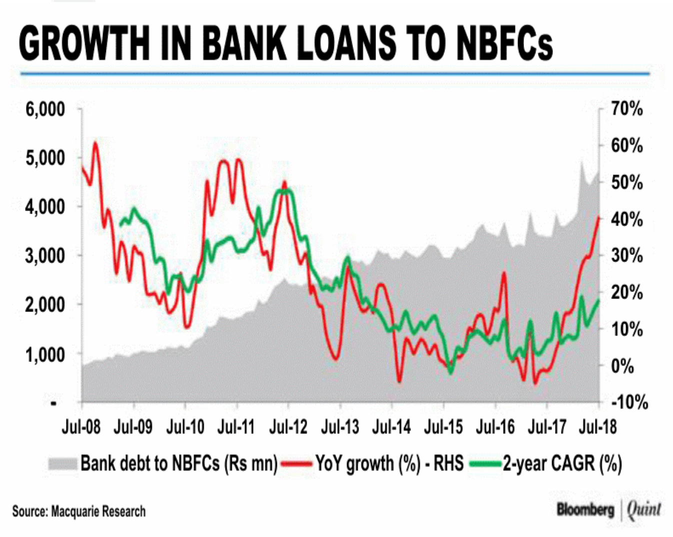
Retail lending, which includes unsecured loans, cards, vehicle etc. has enjoyed a phenomenal run in the last 10 years. We think that itself implies some issues down the road are likely, but data so far suggests benign delinquency levels.

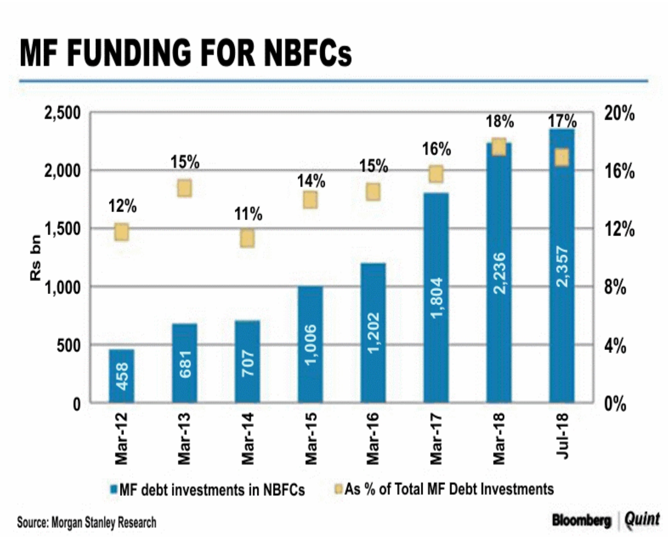
NBFCs' Risks Are Larger Than Estimated

In a recent Financial Stability report, the Central Bank highlighted the risks of rising leverage in the NBFC sector. The report noted that NBFCs were the largest net borrowers from the financial system (primarily commercial banks and mutual funds) with total payables of Rs 7.17 trillion ($98.6 billion), as of March 2018, against receivables of Rs 419 billion ($5.8 billion).

India's Commercial Banks Are Exposed

They have over Rs 4.73 trillion ($65.4 billion) in exposure to NBFCs**,** while mutual fund investment in debt securities of NBFCs stood at Rs 23.6 billion ($324.7 million) as of June 2018. The chart below, from Macquarie research, shows that bank lending to the NBFC sector in recent months increased well over the two-year CAGR.





Housing Finance Companies Are Also Highly Leveraged

The Housing Finance Companies (HFCs), similar to NBFCs, are highly leveraged. Gross payables stood at Rs 5.3 trillion ($72.9 billion) versus the receivables of Rs 312 billion ($4.3 billion), as of June 2018.

IL&FS: Too Big to Fail?

The company has $27 million in cash against the repayment schedule of $500 million during the second-half of 2018. IL&FS's net worth, at 7% of total borrowings at the end of financial-year-ending March 2018, is very low. Also, the net-worth-to-assets ratio stands at just 4.7%, a third of the industry average of 14.2%.

Nomura research estimates that 64% of the IL&FS group's liabilities are in the form of bank loans, accounting for 0.5% to 0.7% of total outstanding loans in the Indian banking system. Not only do banks have direct exposure to IL&FS, they have also lent money to some projects where the company has a stake, escalating the risk of a rise in banking bad loans.

The Emerging Liquidity Crunch is Also Exposing the System to a Systemic Risk

According to the Bloomberg Economics India Banking Liquidity Index, this month liquidity conditions in India flipped to a deficit of Rs 1.4 trillion ($19.3 billion) from a prior surplus of Rs 580 billion ($8 billion).

Asset Duration Mismatches Aren't Helping - Interest Rates Are Rising

India Ratings & Research recently pointed out the vulnerability of NBFCs to tight liquidity environments. The study notes that liquidity shocks at some of the large NBFCs that carry short-term asset-liability mismatches would result in refinancing challenges and squeezing net-interest margins. The sector has recently been moving towards short-term borrowing, as that was cheaper by 100 bps versus long-term funds, creating an asset-liability mismatch. In a recent note to investors, CLSA noted that yields on the one-year AAA-rated corporate bond has increased to 8.6% from 6.9% in the last twelve months. Furthermore, the spread is widening on lower-rated borrower, *further increasing the risk of default.* During the same period, one-year A-rated and BBB-rated bond yields jumped 200 bps to 10.7 and 11.9%, respectively.

Bank Non-Performing Loans at 12.1% of Total Bank Advances

For the year-ending March 2018, gross non-performing assets (GNPAs) stood at 12.1% of total bank advances. The Central Bank estimates that under a baseline scenario, the GNPAs could grow to 16.3% of total advances during the current financial year. Historically, India's Central Bank forecasts have underestimated the NPAs.

Recently, India's former Central Bank governor, Raghuram Rajan warned that the government's aggressive lending practices to medium and small enterprises (MSMEs) could form the next build-up of non-performing loans.

The Central Bank Has Increased Scrutiny of Private Banks' Governance Issues and the Under-Reporting of Stressed Assets

In recent months, the Central Bank has been pressing on management changes at three of the largest private sector banks. Last week, the Central Bank rejected Yes Bank's petition to increase the tenure of its CEO. It has also asked the CEO of Axis Bank to step down, and the CEO of ICICI Bank is under investigation for alleged impropriety in loan approvals.

Recent events do not bode well for the country's financial system and in-turn for the economy. The financial regulator is working to clean up the sector. However, the process has been slow and painful. The malaise could well spread further before it gets any better.

Market Looks Vulnerable

As shown in the chart below, the Bombay 30 Sensex is trading 22% above the 200-week moving-average (MA). The lengthy advance in this market has not tested this long-term MA since February 2016, which indicates the uptrend is extended.

At the time of writing, we have just 6.1% in India in two defensive companies with overseas earnings. These are software blue chip, **Infosys**, and pharma company, **Sun Pharma**.

Oil

Our oil stocks have done well in the recent quarter and we may see some pullback short-term. However, we remain very optimistic for the sector as the winter approaches and here is a reminder of why we like the sector.

Global oil demand is expected to set record highs in each of the next few years as the IEA forecasts growth of 1-2 million barrels per day every year through at least 2023. OECD crude inventories are below the 5-year average for this time of year and are at the lowest level since February 2015.

Concerns about tight supply have driven prices up recently and the tipping point seems to have been concerns that China is considering reducing its oil purchases from Iran. While oil production in Iran dropped noticeably by 100,000 barrels per day in September, further decreases in Venezuelan output are also likely because of the state crisis there. Equally, questions remain over Libya's ability to maintain its current production level of 1 million barrels per day in the future. The more severe scenario would be some kind of geopolitical shock resulting from a US-Saudi standoff after the shocking news of recent days.

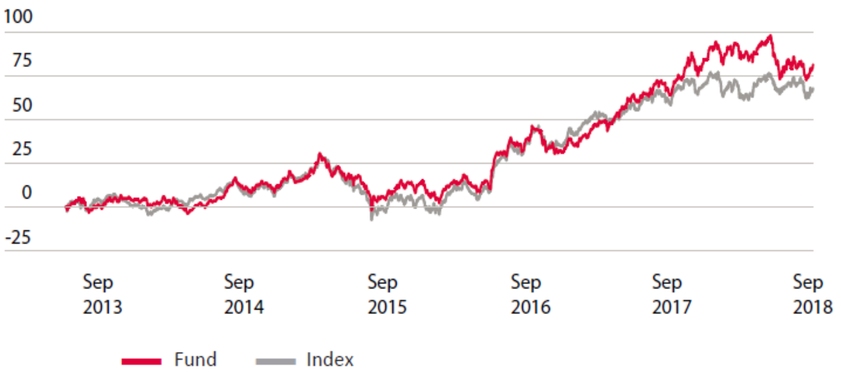
PORTFOLIO PERFORMANCE

Performance Summary (%)
Period ending 28.09.2018

	U (GBP)	Benchmark **
1 Month	0.74	-1.69
3 Months	-1.08	-0.10
YTD	-1.17	-1.79
2017	38.25	25.43
2016	16.21	27.70
2015	2.14	-3.85
2014	7.59	9.51
Since Launch+	82.22	67.82
Annualised 3 years	19.92	19.37
Annualised Since Inception	12.11	10.37

Source: Morningstar
**MSCI Asia Pacific ex Japan
+Launch Date: U: 01.07.13

Fund Performance – Class U (GBP) (%)



Source: Morningstar. Total return net of fees.
Performance since launch of Class U GBP share class - 01.07.13

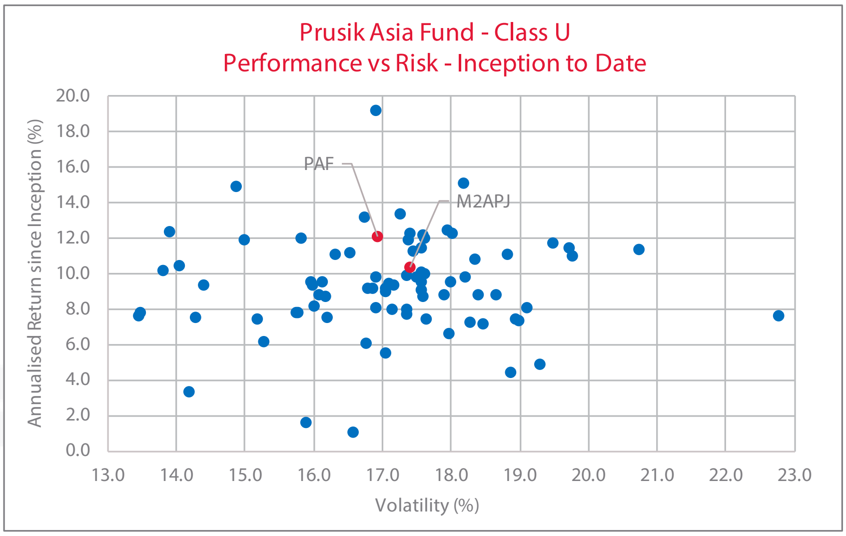
Monthly Performance Summary (%)

	Jan	Feb	Mar	Apr	May	June	July	Aug	Sept	Oct	Nov	Dec	Total
2018	3.14	0.11	-2.14	1.19	3.2	-5.3	-0.96	-0.86	0.74				-1.17
2017	2.50	2.15	6.46	-0.63	5.92	2.63	2.73	3.70	-3.76	6.20	2.33	3.05	38.25
2016	-5.66	2.09	3.24	-0.15	-1.79	9.96	6.53	4.45	0.68	3.99	-4.65	-2.42	16.21
2015	5.39	-2.00	5.34	0.30	0.03	-4.71	-2.81	-6.95	-0.05	5.68	1.42	1.33	2.14
2014	-2.94	1.59	0.06	-4.43	2.68	1.31	3.19	6.53	-2.15	2.37	0.74	-1.12	7.59

RISK ANALYSIS

Risk Metrics	Fund (%)
Beta	0.83
Alpha (%)	1.86
Sharpe Ratio	0.71
Volatility (%)	16.93

Source: Morningstar
Since Inception: U: 01.07.13



Source: Morningstar

THEMATIC & GEOGRAPHICAL BREAKDOWN

Top 5 Holdings (%)

Fila Korea Ltd	4.3
China Railway Construction	3.7
CNOOC Ltd	3.5
PetroChina Ltd	3.5
China Communications Construction	3.4
Total Number of Holdings	37

Portfolio Financial Ratios

Predicted Price/Earnings Ratio	13.3
Predicted Return on Equity (%)	14.9

* Fiscal year periods

Thematic Breakdown (%)

Infrastructure/Logistics/Property	18.3
Energy/Energy Services/Resources	15.1
Local Brands	13.0
Financialisation	10.8
Healthcare	10.4
Artificial Intelligence/Internet	8.2
Leisure/Tourism	7.9
Vietnam	7.3
Cash	7.0
Education	2.0

Geographical Breakdown (%)

Hong Kong/China	52.1
India	9.0
Australia	7.9
Vietnam	7.3
Cash	7.0
Korea	6.9
Singapore	4.8
Taiwan	3.1
Philippines	1.9

All data as at 28.09.2018. Source Prusik Investment Management LLP, unless otherwise stated.

FUND PARTICULARS

Fund Facts

Fund Size (US)	125.44m
Launch Date	07.10.05
Fund Structure	UCITS III
Domicile	Dublin
Currencies	USD (base), GDP, SGD

Share Class Details

Class 1			SEDOL	ISIN	Month end NAV
A USD	Unhedged	Non Distributing	B0MDR72	IE00B0M9LK15	262.58
B USD	Unhedged	Distributing	B0M9LL2	IE00B0M9LL22	262.75
C GBP	Hedged	Distributing	B18RM25	IE00B18RM256	140.26
D SGD	Hedged	Distributing	B3LYLK8	IE00B3LYLK86	359.78

Performance fee based on individual investors' holding.

Class U			SEDOL	ISIN	Month end NAV
U GBP	Unhedged	Distributing	BBQ3756	IE00BBQ37560	182.22

Performance fee based on fund performance as a whole.

Management Fees

Annual Management Fee

Class U: 1% p.a. paid monthly in arrears

Other Classes:1.5% p.a paid monthly in arrears

Performance Fee

Class U: 10% of the net out-performance of the MSCI Asia Pacific ex Japan Index with a high-water mark paid quarterly.

All classes except Class U: Provided the fund achieves an overall increase of 6% a yearly performance fee of 10% of total returns will be applied.

Dealing

Dealing Line	+353 1 603 6490
Administrator	Brown Brothers Harriman (Dublin)
Dealing Frequency	Daily
Min. Initial Subscription	USD 10,000
Subscription Notice	1 business day
Redemption Notice	1 business day

Fund Manager

Heather Manners
Tel: +44 (0)20 7493 1331
Email: heather.manners@prusikim.com

Sales & Marketing

Mark Dwerryhouse
Tel: +44 (0)20 7297 6854
Mob: +44 (0)7891 767 386
Email: mark.dwerryhouse@prusikim.com

Elaine Dennison
Tel: +44 (0)20 7297 6858
Fax: +44 (0)20 7493 1770
Email: Elaine.Dennison@prusikim.com

Prusik Investment Management LLP
6th Floor
15–16 Brook's Mews London W1K 4DS

Web: www.prusikim.co.uk
Email: enquiries@prusikim.com