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Prusik Asian Smaller Companies Fund

Quarterly Investment Report
31 March 2015

FOR PROFESSIONAL INVESTORS ONLY

PASCF Quarterly March 2015

In the first quarter the Prusik Asia Smaller Companies Fund fell 0.9%, while the index rose 4.5% over the period. There are several reasons why this occurred.

Firstly, we undertook a significant restructuring of the portfolio during the quarter, reducing the number of companies from over 50 at the end of December 2014 to 33 at the time of writing. The reason for this is that we believe our performance in 2014 was impacted by too long a tail of smaller holdings which both let down and offset the very good performance of our major themes and highest conviction stocks in the portfolio. The aim of this restructuring is to focus on a smaller number of our higher conviction holdings and themes. A key question we are asking ourselves for all the remaining holdings is: “Are these businesses which we can envisage becoming several times larger in the coming 3-5 years?” We are confident that the answer to this question is adamantly “Yes!” for all the companies which remain in the portfolio.

In the process of increasing concentration in the fund, we reduced the fund’s exposure to China in the early part of this year. In retrospect this proved to be incredibly frustrating decision given the extraordinary performance of Chinese small caps in recent weeks. That said, the Fund kept a meaningful weighting in China and Hong Kong, 22% as of the end of March and this proved to be a key contributor to the fund’s strong return in April of 7.2%, 1.4% ahead of the index. Overall, we feel that while some short term performance at the beginning of the year was compromised by the restructuring, the long term outlook for the fund is now far stronger. We believe these changes have led to a significant uplift in the quality of the fund’s holdings and a decrease in the fund’s cyclical and corporate governance related risks, thus yielding a huge improvement in the fund’s overall risk-reward profile.

Finally, there were a few stock specific reasons for the lacklustre performance in the quarter. Firstly, small cap cyclicals in Indonesia and Korea saw a period of weakness at the beginning of the year. As this weakness coincided with our move to reduce the cyclicality in the fund, exiting these positions at this time slightly hampered performance. However, as previously discussed, we believe the fund is now in a much stronger position having now reduced its exposure to such cyclicality. Secondly, we took profits in two of our India holdings, **Ceat Ltd** and **Persistent Systems Ltd**, exiting the former completely and reducing our weighting in the latter. From the time we first purchased the shares in these companies in 2014 to the end of 1Q15, they have contributed 211 basis points to performance. However, during 1Q15 shares in both stocks corrected from their highs, thus acting as a drag on performance on a year to date basis at the time of the sales. Finally, **Max’s Group Inc**, manager of a strong portfolio of restaurant chains in the Philippines, which we purchased at the beginning of the year has yet to see the market give the stock the value we believe it deserves. To our minds this is just a question of patience.

Outlook

We believe the outlook for Asia is very positive. Currently, Asia offers much better growth and value compared to the US (more on this below) and has significant scope for further interest rate cuts in a number of countries. It also has many industries and themes which are seeing very strong growth and which are very investable. Despite all of this, foreign investors still seem cautious of Asia and view the region with a very sceptical eye. This is usually a very good indicator of further upside!

Local investors, however, are starting to show up and make significant impact in their markets. This phenomenon is represented in the Fund via our 'financialisation' theme, whereby we invest in companies supplying financial services and saving advice, especially online. We also believe that the local savings industry is likely to be a surprisingly positive force in Asian markets in the future.

Reform will also remain a powerful driver, and nothing is more supportive of share prices than rising returns to shareholders, often one of the key objectives for carrying out reform in the first place!

We are excited about the newly pared down portfolio. We believe that every one of our companies has the potential to be significantly larger than it is today, in most cases by a magnitude of multiples. We have significantly improved the quality of the holdings in the fund and now have meaningful positions in our favourite, high conviction companies. We are focused on themes and companies (not countries) as our preference is to let the themes and companies do the work themselves. This may mean that our returns do not match the index over short term periods, but we do expect to see significant upside from the fund over the long term.

Despite a weak first quarter for Vietnam, we remain very confident for the long term outlook for the country (more on this below) following a visit there in January, and still feel there is significant upside to the market from here. Equally, we believe India still has further upside in the coming years, but our recent visit there suggests a few months more consolidation and correction is possible. The Indian economy has not really started to recover yet and interest rates are still too high. This is ultimately a positive scenario in that the country still sits on the brink of a macroeconomic turnaround, but more government activity is necessary to unlock this positive potential. We are reluctant to change the fund's weighting in either Vietnam where we have 10.7% weighting, or India where we have a 9.1% weighting, as we still like the thematic growth stories behind the companies we hold in these markets.

Indonesia is also going through a correction period as investors assess Jokowi's first year and lack of action. Stocks here have underperformed the region in recent months but many still sit close to 5 year highs. Although interest rates can and should fall from here, the Indonesian economy remains very dependent on commodities with few obvious new areas for growth. With this in mind we have exited our Indonesian holdings, as we touched on above.

Overall, the key positive forces for the first quarter all came from North Asia, especially China. Thematically, we saw the strongest performance from our China infrastructure theme, which has turned in some excellent first quarter growth numbers. If anything, the story here seems to be getting even better (more on this below).

India Visit

In June 2014, when we last visited India, valuations were much lower and optimism was much higher as news of the Modi victory was still fresh. At that time India felt like a much more obvious investment case. On our recent trip it was clear that there are still huge growth opportunities. Burgeoning tourism, the explosion of mobile data, a rise in demand for education services, a shortage of hospitals and good healthcare and the very early arrival of modern retail brands are leading to very strong growth numbers for companies in these sectors. The overall economy, however, remains flat with the much expected recovery still in the wings. As a result, logistics, real estate, infrastructure and autos show promise but, as yet, growth is more of a hope rather than a reality. The Indian domestic investor is also starting to invest more in their own stock market but, at this stage, this is still a green shoot.

We are still very optimistic on the long term growth prospects for India but we are concerned that earnings expectations need to be trimmed in the short term and as a consequence there are some risks to the investment case in the nearer term. Political risk also hovers. During the trip an Anti-India rally in Pakistan showed the cracks in the Indian government, highlighting the ideological gaps between the Pakistan Democratic Party (PDP) and Indian's ruling Bharatiya Janata Party (BJP) and the lack of a coherent Pakistan policy. In addition, interest rates are far too high, with local companies still paying double digit interest on loans. They need to fall significantly and indeed could do so as inflation remains very low. However, the political standoff between the Reserve Bank of India (RBI) and the government stands in the way of a pragmatic move, meaning optimism for a sharp fall in rates is probably too high. Until rates do drop substantially it is also very hard to see the investment case for the much needed big infrastructure projects, which rarely have return rates over 8%, at current borrowing rates.

On this trip we met 35 mid-cap companies and here are some of our notes and impressions.

- **Modi is still very popular:** We quizzed everyone we met from company officials, our our drivers and the people working in the hotels where we stayed. He is perceived to have put India back on the world stage and even our driver in Delhi knew that the stock market had been very strong. Further, the companies we met all see the nationwide implementation of the Goods and Services Tax (GST) next year as a very big positive. However, we are coming up to Modi's one year anniversary, and his government still has not managed to deliver a pick-up in economic growth, a meaningful cut in interest rates or the much needed kick start in infrastructure projects. Given this we suspect we will see the honeymoon period continue to wane from here in the short term.
- **Interest rates – expectations are too high:** There is a broad expectation and hope amongst corporates that the RBI will deliver significant interest rate cuts. Many of the companies we met talked about their hope for anything from 50-300bps of interest rate in the next 12 months. The key rationale for this is that Indian corporates still pay over 12% on loans for infrastructure, whereas long term IRRs are closer to 8%. As such, there is very little incentive to invest, even if the policy uncertainty is removed. However, aggressive easing from here seems unlikely as the

RBI has a stubbornly cautious inflation forecast of 5.8% and RBI's guidance is to have a buffer of 150-200bps ahead of inflation for interest rates. On this basis, if inflation continues to be low and there is a good monsoon, then 50-75bps of interest rate cuts look achievable, but not much more. We would be more positive on the Indian growth outlook if we believed that interest rates were likely to come down by at least 100bps in the next 12 months, but with a Rajan led RBI this seems unlikely.

- **Recovery – patchy at best:** Almost without exception the companies we met said that the economic recovery has been patchy so far and that they are not yet seeing any meaningful pick-up, although most are still holding out hope for this financial year. CLSA's economist, Rajeev Malik, commented in a recent article that "*Investment recovery continues to be held back by structural factors, institutional issues, supply-side constraints and policy uncertainty*". Here are some comments from our company meetings regarding the companies' own experience and expectations for growth.

- **CEAT Ltd (tyre maker):** Management are not seeing any direct change on the ground, although sentiment is positive and they are seeing green shoots in the commercial vehicle market.

- **Apollo Tyres**: During the last couple of years demand growth has been slow, with demand for trucks tyres being poor and demand for passenger vehicle tyres slightly better. The company is still not seeing a big pick-up in demand though.

- **Credit Analysis & Research (credit rating agency):** Management have seen some improvement in demand for credit ratings over the last 12 months, but banks are still reporting large NPLs and interest rates need to come down for demand to improve meaningfully.

- **All Cargo (logistics business):** In the last 3-6 months there have been some positive developments in infrastructure. Infrastructure projects were running at 79% utilisation in March 2014, but are now at 95% utilisation. Logistics in India needs to improve desperately as logistics costs there equate to 14% of GDP, yet this figure could easily come down to 9-10% if infrastructure gets moving.

- **Havell's (household appliances):** According to management, sentiment has changed post the election but there has not been much change on the ground. For example, the company say very strong sales growth at the start of FY15 but by 3Q revenue growth had fallen to low single digits.

- **InfoEdge (online recruitment plus a portfolio of other online businesses):** There has been a recovery in demand compared to a year ago, but it has been patchy. The best two quarters were those around the election.

- **Akzo Nobel (domestic paint):** Management have been seeing an improvement in the decorative paint market and some improvement in industrials paint, but no uptick in automotive business.

- **MakemyTrip.com (leading online travel company):** The government is focusing on improving infrastructure and this is expected to have a knock on positive impact on leisure and travel. The surge in mobile internet is a game-changer.

- **Property market – office is improving, residential property is still very slow:** In Delhi and Mumbai there is a real and noticeable improvement in office rentals, although these improvements are more noticeable in some areas versus others. For example, in Delhi the strongest rental reversions are being seen in Gurgaon, while Noida is more patchy. The best office space locations have seen occupancy rates increase to close to 100% and rentals have increased by as much as 50% over the last 2 years in the best buildings. Multi-national companies are a key driver behind this pick-up in demand.

  The residential market tells a slightly different story. It was described as still very slow and inventory levels are high at 3 years at a country level. However, on a province by province basis Hyderabad and Chennai look better, whilst parts of Delhi continue to deteriorate. Demand is there, but developers are very resistant to falling prices, so asset turns continue to be low.

- **Internet-mobile boom a game-changer:** Although national internet and smartphone penetration in India is still relatively low, one theme that kept coming up was how online activity is becoming a core part of many Indian companies' business models. For example, the cinema operator, **PVR Ltd**, now derives 26% of its ticket sales from online distribution, up from 16% 2 years ago. Elsewhere, Dish TV India Ltd, a kind of Indian equivalent to Sky PLC, has a new app which allows customers to watch 35 channels on their iPads for which they management hope to acquire at least 1 million subscribers in the next few years. Management are also looking to come out with their own version of "Netflix". Info Edge India Ltd, the Indian internet company with the bulk of its sales and profits coming from its online recruitment business, is now getting 40% of its traffic from mobile. MakeMyTrip Ltd, the online travel company, claims that a third of its customers now make travel bookings online. The listed internet sector in India faces some challenges as the unlisted companies have access to a huge amount of capital via the private equity and venture capital markets, with much of it coming from the US, so the competitive environment is fierce. For the sector overall, sales growth is strong, but earnings growth is more subdued. Similar to elsewhere in the world, demand for talent is high and as a result technology engineers are seeing wage growth of at least 15% a year.

- **Hospitals and healthcare are a growth sector:** The healthcare sector in India is growing rapidly with annual growth rates in the supply of hospital beds running at 25-30%; however, this still cannot keep up with demand. The 3 key players in the listed hospital space in India are Apollo Hospitals Enterprise Ltd, Fortis Healthcare and Max India Ltd. All 3 are growing extremely fast and have plans for large scale expansions over the next 3 years. They are investing in new growth areas such as oncology and maternity, both of which are higher margin, and so they expect EBITDA margins to improve from the already high 30% that they are seeing at present. Fortis Healthcare Ltd has recently embarked on a radical restructuring programme, shifting to an asset light model via selling its hard assets into **Religare Health Trust**, which is listed in Singapore. The main issue here is very high valuations.

- **Tourism:** Tourism, a favourite theme across Asia for us for some time now, is also on the rise in India. Outbound tourists from India now number 18-20 million people per year. So far the most popular destinations are the Middle East and Thailand and half of all outbound tourists limit their travel to places within a 5-6 hour travel radius. The market is quickly becoming more sophisticated with travellers graduating from group travel to individually planned trips.

- **REITs are coming:** Several of the property companies that we met as well as the rating agencies identified REITs as one of the next exciting opportunities on the horizon in India. If all goes to plan it is possible that we will start to see issuance within the next year. There are still some question marks regarding the tax structure, although this may be amended as the budget for the coming financial year makes its way through parliament. We would expect **Oberoi Realty Ltd**, a holding in the Prusik Asia Fund, and **Credit Analysis & Research Ltd**, a holding in the Prusik Asian Smaller Companies Fund to benefit from the emergence of REITS in India.

  We would like to highlight 3 important new themes in particular which we have identified in India.

- **'Millennials' - the 18-30 generation is increasingly shaping consumer behaviour:** The average age in India is 27 years old and this is starting to impact corporate strategy across the country. For example, Zee Entertainment Enterprises Ltd, operator of ZeeTV, has started a new channel, complete with separate branding, containing content a world away from the traditional fare of family dramas. The new programming contains dramatic themes such as the mafia governing the coal industry, the survival and triumph of a child widow and lots of locations set beyond the boundaries of India, all of which is designed with a younger audience in mind. The channel has already drawn big audiences and will help improve the company's advertising revenues which, in turn, management intend to use to update content on a wider basis across existing channels.

Future Group, a leading retailer in India, includes a men's and women's Western clothing business focused on the younger generations. It aims to be "like Zara but cheaper", but with an Indian twist on colour choices and certain local preferences. This is the very definition of a 'local brand'. On enquiry during our travels, everyone confirmed that wives, daughters and working women everywhere virtually never wore traditional clothing anymore unless they were going to a big formal event. In the case of the under 20s, wearing traditional clothing at any time is "a big conversation" (teenagers, it seems, are the same the world over!) except when they want to "stand out and look fabulous", whereupon they might wear a sari to "be different!'"

Finally, Speciality Group, which owns a portfolio of young and vibrant restaurant chains, the most successful of which is called 'Mainland China', has just started a branded wine bar chain. Management's objective to provide fun and lively places where young people can meet and buy cheap alcohol clearly mimics the social trends and successful business models of the West.

- **Women - the 'mancession' is not just a Western phenomenon:** Last year a Hindi budget film costing just US$2 million to make won half a dozen industry awards, swept the Indian box office and captured the imagination of both men and women (indeed, it was a man who brought it to our attention!). The movie is called 'Queen' and the storyline is about an under-confident girl whose parents allow her to forgo an arranged marriage and marry for love. However, just two days before her wedding she is jilted. The protagonist's life takes a very different trajectory when she decides to still go on the honeymoon anyway, which her parents had booked, to Paris and Amsterdam. Once there she meets a cast of characters with whom she learns to enjoy life on her terms. She goes sightseeing, dancing, drinking, wearing revealing clothes and so on – you get the picture! In the middle of all of this she also manages to win a national TV baking competition! Needless to say the hapless ex-fiancé returns to try to get her back, but the protagonist's newly acquired confidence and perspective is such that she turns down both his pleas and those of his parents (of more cultural significance in India than the UK!) and walks off into the sunset, single and happy.

  The aforementioned Future Group is one company which is adamantly stating in its corporate strategy that management believe women will play an increasing role in how money is spent and are a powerful new market in their own right. Not only is Future Group tailoring its fashion brand accordingly, but also management believe that as more women enter and/or re-enter the workforce the need for ready prepared food and easier meals will increase. In one of the company's other retail businesses, which is focused on food, management are positioning their new food brands accordingly with a focus on products such as pasta, sauces and cereal, the latter now increasingly replacing the traditional cooked breakfast for the younger generation.

- **Local Brands – a familiar tune but just the beginning:** Right across Asia and for many years now we have seen how local brands have succeeded versus foreign brands. The cycle of this much repeated theme goes that once the middle class moves towards Western food habits, and organised retail gets a foothold, the Western staples that have dominated a previously small market (usually Nestle and Unilever PLC) are copied by local food producers who create the number two brand. Crucially though, these local food producers add two key things to the equation. Firstly, they price their products at a discount, not because they are inferior products, but often because they benefit from lower cost manufacturing bases. Secondly, they introduce a local twist to the products on flavour or taste. Once again returning to Future Group, this company is busy creating its 'own label' products in as many food categories as it can to sell in its extensive network of convenience stores and hypermarkets. Management claim that the move towards 'own label' products is purely to cut out the middle man and in turn increasing margins. However, importantly, management are creating in many categories the ONLY other brand label in India. For example, to date Kellogg's is the only significant cereal brand available in India. As such, Future Group's modest and under the radar 'own label' strategy is most possibly a stealth route towards becoming India's first local brand in many product categories. Management have already had early successes with their own label products in ketchup and toilet cleaner!

  We currently have a 9.2% weighting in India. We are expecting further pullbacks over the coming months, largely driven by sentiment and impatience, during which time we are looking to add. We think India still offers excellent growth potential and would be adding to our positions at prices 10-15 % lower than where they currently sit.

Smart Textiles

It is tempting to think that when there is a change in fashion that this change is just that – a temporary shift in taste that will rise, peak and ultimately falter before lying low for some decades and later being revived for another generation. However, it is also important to acknowledge that large scale permanent shifts in what we wear also occur. Arguably, when these permanent shifts occur it is because there are far reaching demographic, financial and resource related reasons at play. It is not a question of fashion. Clear - although perhaps clumsily obvious - examples of this would be the fact women were long ago released from having to wear boned corsetry as well as bell shaped structures over which their dresses were draped. Arguably, these changes were far more than the fickle whims of fashion. Traditional corsets wreaked havoc with women's health and underwired skirts and dresses were simply not an option if women were going to take on the practical occupations that so many did in the First World War. In addition, manmade fibres have been developed as a result of some countries having a greater natural advantage in cotton and the disadvantaged countries innovating their way out of the problem. In short, what we wear changes over time and those changes are not always about fashion.

We believe that what we are observing in functional fibres and smart textiles represents another permanent shift in clothing and that this could not be further from a fad. We have suspected this was the case since we first came across functional fibres and smart textiles, but a recent trip to Taiwan, where our analyst visited a large number of textiles companies spanning different parts of the textile manufacturing value chain, different customers bases and different levels of technology, has enhanced and crystallised our understanding of what's afoot (no pun intended). The companies visited were **Toung Loong Textiles Manufacturing**, one of the most advanced yarn dyeing companies globally, Feng TAY Enterprise Co Ltd and Pou Chen Corp, leading footwear suppliers to NIKE Inc, which has been at the forefront of the recent wave in 'flyknit' footwear, Makalot Industrial Co Ltd Industrial Co Ltd, garment manufacturer for Gap Inc, Fast Retailing Co Ltd (Uniqlo) and more recently Under Armour Inc, Tainan Enterprises Co Ltd, a peer of Makalot Industrial Co Ltd Industrial Co Ltd's and Far Eastern New Century Corp which has been singled out by NIKE Inc as a material science pioneer, tasked with coming up with sports tops which will 'talk' to our i-Watches.

So what is driving this trend? Conversations with the textile companies combined with our own observations leads us to believe that the emerging structural change relating to smart textiles has multiple drivers. In fact, we believe that it is this confluence of multiple trends which makes the wide adoption of smart textiles more likely to be a permanent shift. Intriguingly, many of these individual drivers are themes which we are already very interested in and are already represented in our portfolios. These themes include disruptive technologies, health and wellness, the environment and the global rise of the middle class. Other themes which also come into play include rising internet penetration, social media, smartphones, automation, the 'Internet of Things' and Millennials.

Firstly, perhaps one of the most important drivers of this trend is technology. The majority of us now exist almost surgically connected to our smartphones and quite often with a tablet to hand. We are starting to open our eyes to smart technology in the home and i-Watches. These devices now give us access to information and the ability to perform functions on the move which were quite unimaginable 5-10 years ago. In a world where such devices are now the norm, we believe it is inevitable that consumers are now expecting the same enhanced level of performance in other areas of day to day life. What we wear is the natural next step. Functional fibres and smart textiles without doubt provide function and performance in ways which we would not have previously demanded. As we have mentioned in our last quarterly, smart textiles makes for clothes which are lighter, more comfortable, provide better body temperature regulation and possibly, in some cases, even make the wearer look much slimmer!

Arguably, these are just baby steps though. At a more advanced level, it is possible to make professional sportswear out of recycled plastic bottles, satisfying the rising desire by governments and the consumer to take better care of the environment**. Far Eastern New Century did just that for 5 national football teams at the last World Cup. Taking things a step further, the same company is currently working in conjunction with NIKE Inc to develop clothes which will be embedded with sensors capable of measuring physical attributes such as our heart beat and sending that information to our smart watch.**

Under Armour Inc has recently proposed that our clothes should do even more, with the data collected by sensor embedded clothing actually appearing on the sleeve of our top, thus removing the need for an external device.

Other important factors which we would like to touch on briefly as key drivers of demand for functional fibres and smart textiles are as follows. Firstly, more people are allocating an increasing amount of their leisure time to cycling, swimming, yoga and other active pursuits as education around the importance of exercise improves. Rising awareness of longer life spans and a desire to maintain our health might also be an influence here. Secondly, social media and recording individual performance, posting photos, sharing comments about sporting achievements and so forth turns what would have ordinarily been the pursuit of one individual into the activity of a whole 'tribe'. The same behaviour on social media also satisfies an arguably new desire for individuals to 'measure' themselves and compare results with peers in a new and slightly twilight-zone-style battle / survival of the fittest. Thirdly, new production processes and material types are enabling companies in textile and footwear manufacturing, which are highly water intensive and polluting industries, to reduce their water usage and emissions and increase automation. These environmental improvements satisfy both a growing interest from the consumer in protecting the environment and rising pressure to conform to self-imposed 'corporate social responsibility' mandates for the likes of NIKE Inc. Finally, improving education, longer life spans, connection to the internet and rising disposable income are all the hallmarks of the global rise of the middle class. As such, there is possibly no better play on the theme of the growing middle class across developing markets than functional fibres and smart textiles.

Trans-Pacific Partnership, Vietnam and Makalot Industrial Co Ltd

The Trans Pacific Partnership (TPP) is a proposed trade agreement between the US and 11 other countries. In Asia this includes Australia, Brunei, Malaysia, Japan, Singapore and, importantly, Vietnam. Vietnam is currently the second largest apparel exporter to the US with a market share of 11% compared to 42% for China. Currently these Vietnamese exports to the US are subject to an 11.5% import tariff, but thanks to lower wages and lower costs in general in Vietnam, the cost advantage of manufacturing garments there remains around 9% cheaper than doing so in Central America, despite the existence of free trade agreements in those zones. However, once the TPP proposals are in place, companies manufacturing garments in Vietnam expect to enjoy a massive 17% cost advantage to manufacturing garments in , for example, Mexico. China is also comparatively significantly more expensive. This new advantage from TPP will add nicely to the margins of the likes of NIKE Inc and Gap Inc who are already manufacturing in Vietnam. Indeed, Deutsche Bank's estimates suggest that margins for these major sportswear and casual wear brands in the US could increase by 150-400 basis points! Over the coming years, the introduction of TPP is also therefore highly likely to increase significantly the amount of market share Vietnam enjoys in the garment industry.

Clearly the timing for the TPP is important. It looks as though both houses in Congress will vote before the end of June this year, with the final approval expected towards the end of 2015. It is reasonable to expect full implementation of TPP to have taken place by 2017.

Taking up the story, we spoke to Makalot Industrial Co Ltd, which is a Taiwanese mass market garment maker, with over a third of its manufacturing capacity in Vietnam. Makalot Industrial Co Ltd currently has about 10% of its volume going to the 'functional sportswear' segment, or what we would deem 'smart textiles', but acknowledges that this part of the business is growing so fast that it could reach 20% of sales in just 2-3 years' time. Last quarter we wrote about the shift towards using functional fabrics in the casual wear sector, a notably huge opportunity given that the casual wear market is 8 times larger than the sportswear sector. This also represents a very clear growth opportunity for companies like Makalot Industrial Co Ltd.

Makalot Industrial Co Ltd also updated us on some other factors which will have huge impact, not just on Makalot Industrial Co Ltd, but very possibly Vietnam. They also tell a story of what is happening in China. Importantly, almost all of Makalot Industrial Co Ltd's larger customers such as Gap Inc, NIKE Inc and Under Armour Inc are consolidating their suppliers to about *one third* of the number they are using today. Ma nagement expect this process to take place over the coming 3 years. It is very informative to look at the numbers involved. For example, in the case of Gap Inc, which currently uses around 1,000 suppliers, its supplier base will shrink to around 300. This push is so dramatic that Makalot Industrial Co Ltd told us that over the past year Under Armour Inc has gone from giving the company $2million of orders in a year to $10 million of orders in a year.

So why is this consolidation in the supplier base happening? Firstly, having a more consolidated supplier base enables the likes of NIKE Inc and Gap Inc to get greater access to shorter lead times. From time to time, the branded clothing retailers will need 'quick response orders', namely orders being fulfilled within 30-50 days, much faster than the usual 90-180 days turnaround time. There are not that many garment makers with sufficient scale which are capable of these shorter lead times and so it makes sense for Gap Inc and NIKE Inc to allocate more of their supply needs to Makalot Industrial Co Ltd as a company with this capability. According to Makalot Industrial Co Ltd, quick response orders make up around 30% of its sales at present, but this is expected to reach 40% by the end of 2015.

Secondly, TPP is also a major factor behind vendor consolidation. The dramatic reduction in cost which will follow from this programme will force the likes of Gap Inc and NIKE Inc to concentrate even more of their supplier base on companies with manufacturing facilities in Vietnam. The fact that average monthly wages in Vietnam are now just $319 versus $686 in China creates an added attraction, bordering on an imperative, to manufacturing in Vietnam.

The final element behind the consolidation is that the major clothing brands are keen only to source from vendors with very strong 'socially responsible investing' (SRI) or 'corporate social responsibility' (CSR) values and policies. This focus is partly driven by the fact that the Millennial generation is more environmentally conscious than those before them, and also partly from a very real need to reduce dependency on water and energy, both from a practical and a cost perspective. Numerous Chinese suppliers are unlikely to qualify on this basis, which in turn, is likely to lead to a reduction in vendor numbers. The Taiwanese and Korean garment manufacturers are well positioned to benefit from this shift.

(Source Prusik)

Toung Loong Textile Manufacturing is a Taiwanese company focused on the production and dyeing of a special, high end yarn called Nylon 6,6. Owing to Nylon 6,6's ability to produce very light, soft and stretchy material with excellent recovery properties, it is increasingly the yarn of choice for companies producing sportswear based on 'smart textiles'. At present the company derives around a third of sales from high end sportswear and a fifth of sales from intimate wear, and NIKE Inc and Lulu Lemon are key customers. Our analyst recently met with management in Taiwan and was impressed with what she learned about the company's competitive position. Dyeing Nylon 6,6 is incredibly difficult to do if the yarn is going to be used in solid colour fabrics rather than patterned fabrics because the complexity of the dyeing process normally makes the defect rate very high. However, **Toung Loong Textile Manufacturing** has spent 20 years refining its dyeing process so that defects are kept to a minimum. Management were keen not to go into too many details for fear of its key secrets being leaked to competitors, but they explained that the process of dyeing the Nylon 6,6 yarn bobbins with a low defect rate requires at least 10 challenging steps.

The steps which are particularly difficult to get right include achieving a consistent yarn winding tension when the bobbins are being made, an even temperature and flow of the dye in the vats where the bobbins are submerged, and fixing the colour at the end of the process. Management showed our analyst the 2kg bobbins which the company has to dye and it became clear how it would be challenging to get a consistent colour in both the outer and inner part of the bobbin. **Toung Loong Textile Manufacturing** is a newer holding in the Fund and the stock has already delivered a very positive return. We believe the higher headline multiple for the stock is more than justified by the company's excellent growth opportunity and the industry's high barriers to entry. The photos below show a sample bobbin and the Nylon 6,6 thread stretched out, illustrating how its 'floaty' texture helps achieve the soft-to-touch result for the end product.

Finally, it is worth noting that while TPP has positive implications at a stock level for a number of companies, it is also expected to have a broader positive impact on Vietnam as a whole. As we have written about before, Vietnam's economy has been receiving a boost recently from an increase in foreign direct investment and the TPP agreement will only add to this. In addition, the Regional Comprehensive Economic Partnership (RCEP), an agreement between ASEAN and numerous other countries in Asia, is also under review. Both agreements are likely to lead to an increase in Vietnam GDP. Indeed, UBS believes that TPP membership alone could add a massive 14% to Vietnam GDP over coming years! With all of this in mind, we intend to continue to keep around 10% of the fund in Vietnam.

As an aside, the extent to which we feel Vietnam is likely to take share in both textile manufacturing and manufacturing more broadly has interesting implications for China. On the one hand, as China goes through this transition phase the loss of manufacturing is likely to pose a challenge. On the other hand, the transition to higher value added parts of global value chains and a greater focus on consumption and services should have a positive impact on the Chinese economy in the long term.

Stock Connect and China

Over the past year, China's asset management market has been very active. A number of new policies and guidelines have been issued, or are under discussion, aiming to boost cross-border financial investment. Various capital inflow and outflow mechanisms have also established a 'two-way channel' for cross border financial investment.

On 17 November 2014, the Shanghai-Hong Kong Stock Connect was officially launched. This is a pilot programme which enables investors in mainland China and Hong Kong to place orders through their local securities brokers to trade eligible shares listed on the stock exchange of the other. As such, the Stock Connect opens up another channel for Renminbi to flow across borders as all trades must be conducted in this currency. In the early stage of the programme, stock investments in both directions are subject to total quota and daily quota requirements. The regulatory authorities may change such quotas as and when needed.

It is anticipated that the Shenzhen-Hong Kong Stock Connect will be launched soon with rumours suggesting that the State Council may approve this in the fourth quarter of 2015. The proposed daily investment quota has been increased to Rmb 40 billion and the total investment quota is likely to be removed. This could prove to be another very interesting development for investors as the Shenzhen Stock Exchange has a greater focus on 'new economy' companies such a technology, healthcare and clean energy businesses, unlike the Shanghai Stock Exchange which primarily comprises financials and heavy industrials typically associated with the 'old economy'. Market intelligence also suggests that, if the Stock Connect proves to be successful, China may also put forward a Singapore-China Stock Connect programme.

Clearly the Stock Connect programme has been taken into the hearts of mainland investors who have poured money into China and Hong Kong this year. Record trading volumes and tales of laptop trading of stocks under tables in fruit and vegetable markets has alarmed those with long memories of previous bubbles.Beyond the excitement and potential hype of the Stock Connect programme, what is happening on the ground in China? What shape is the economy currently in and where are the key risks?

In the first quarter of 2015, nominal GDP growth in China was 5.8%. It is notable that nominal GDP growth in China has fallen more quickly than real GDP growth. For instance, nominal GDP growth was 10.2% in 2013 and 7.7% in 2014. What this indicates is that simply 'grandfathering' loans and growing out of the problem is no longer a viable strategy for China. Indeed, according to McKinsey, debt to GDP in China now stands at 282% and debt servicing costs now exceed nominal GDP growth. The upshot of this is that the Chinese economy is becoming more indebted by just paying interest.

Without grandfathering and growing out of the debt equation there are only three options for the Chinese government to alleviate the country's debt problem. Firstly, China can **default**; secondly, China can **socialise** the debt by either raising taxes or by cutting real deposit rates (both are likely to be used but, at present, reducing deposit rates is difficult); thirdly, China can **swap debt for equity**. This is really what "recapitalising" China amounts to – a debt for equity swap – and it is much easier to do this if equity markets are strong. **If we were in China's position we would be trying to engineer a multi-year bull market in equities to make sure the swap takes place on as favourable terms as possible.**

Earnings for the MSCI China, excluding energy, are expected to grow at 11% per annum in 2015 and 2016. Further, companies within select sectors and themes within the MSCI China can or are growing earnings at 20% per annum or more. The index overall is trading on a forward P/E multiple of 15.4x. In contrast, earnings for the MSCI US are expected to deliver zero growth this year and the index is on a forward P/E multiple of 17.3x P/E, or a 12% premium to the MSCI China. We would also note that in China sales growth remains robust compared to many countries around the world and margins are expanding. In addition, capital intensity is continuing to normalise, overcapacity issues are starting to fade and the lower inputs costs are driving a margin revival, led by technology, utilities, transport and other commodity consumers.

We do not for a minute assume that investing in China is a risk free exercise and rising markets will not solve all of its challenges. Indeed, the leverage numbers in China are vast and it is hard to find a historical example where similar levels of leverage have not had serious negative long term macro-economic consequences.

Despite this, and arguably counter intuitively, it is still possible to see that the current run in Chinese equities could continue for some time. Rising returns to shareholders, whether this comes from margin expansion, restructuring or industry consolidation, is a strong tailwind. Moreover, structural changes which are allowing and renewing participation from local investors, as our 'financialisation' theme suggests, could have a far greater positive impact on the markets in China than our current expectations and fears allow us to believe.

Chinese Infrastructure

It is tempting to assume that China, having spent so much on infrastructure in the past decade, now has little to do, or at least the trends are less obvious and so less investable. However, we have identified two specific areas where spending and investment is still at a nascent stage. These are the public transport, especially subway systems and the electric grid.

In China there are some 2,000 km of subway lines, but the government has indicated that they would like to see this number grow to 8,000km by 2020. Intriguingly, this number excludes local government plans to build subway networks in smaller cities and so meaningfully understates the long term opportunity. Furthermore, domestic players in this market could succeed in overseas expansion which widens their growth opportunity even further. In the very long term leading players in this market are likely to benefit from consolidation and M&A in this sector.

Beijing Urban Construction Design & Development Group Co Ltd is a leading design and consulting company for subway systems in China, combined with an infrastructure construction company. The company has a long history of operating in the rail transportation industry in China, having been established in 1958, a time when the market was dominated by state owned companies. Investment in urban transit in China is expected to grow rapidly over the coming years for a number of reasons. Firstly, as urbanisation in China continues, the size of tier 2 and tier 3 cities is set to expand and transport infrastructure in these cities will need to be improved and developed in order to support this change. Secondly, air pollution is becoming an increasingly worrying problem in China, not just in the mega cities, but also in most provincial capitals and other larger cities. Migrating more of the population onto subway systems and reducing people's dependency on cars will help alleviate this problem. Intra-city infrastructure also needs to improve in order to help productivity in China. While it is incredibly convenient to travel between cities in China, once there, getting from one corner to another can turn into a rather desperate exercise. According to CCID Consulting, cumulative investment in urban rail transit in China is expected to total Rmb 2trn between 2014 and 2018.

As well as having this attractive long term growth opportunity, **Beijing Urban Construction Design & Development Group Co Ltd** also appears to be financially strong with net cash on the balance sheet equivalent to 38% of its current market capitalisation. The shares are trading on a 2016 P/E of just 11.0x, pre-stripping out the cash, possibly because the market is unclear how to value the stock owing to a lack of obvious peers globally.

Moving to the electric state grid, this is another key area in China where huge amounts of investment are required.

Figures estimated for spending on a comprehensive upgrade of China's state grid are as high as Rmb 80 billion. One important aspect of this upgrade process is the government's target to increase the automation of electricity distribution in the leading cities from 30% to 50%. The short term upshot of this is that in the coming year spending in certain areas such as 'advanced distribution operations' is due to double. **Wasion Group Holdings Ltd**, a smart meter maker and a company which we have known very well for years, is at the epicentre of this spending program. Despite very strong share price performance of late, it is still on a 2016 P/E multiple of just 12.5x. The company recently produced excellent results and management have guided for 35% year on year growth in the coming year.

Another company which the fund is invested in which is benefitting from investments in the state grid is **Jiangnan Group Ltd**, a maker of electricity cables. While the electric cable industry in China is highly fragmented, it appears to be free of the intense price competition we would normally expect of this industry structure. Importantly, management estimate that one third of spending on the state grid in China in the coming years will be spent on cables. In particular, demand for 'ultra-high voltage' cables is expected to be very strong owing to increasing investments in remote wind and solar farms which require these cables to transmit their power over long distances. This is an area which **Jiangnan Group** specialises in. The company should also get a decent margin lift from rising demand for 'ultra-high voltage' cables as these high end products are also more profitable. **Jiangnan Group Ltd** is also a beneficiary of spending on railways as this is another market where cables are used. At present, only 60% of China's rail network is electrified so this will also be a strong driver.

Finally, **Jiangnan Group Ltd** has successfully penetrated the export market for cables. While export sales represented just 5% of sales in 2014, the pace of growth in this market for **Jiangnan Group Ltd** is not to be underestimated. In the first two months of 2015 the company has already seen export orders equivalent to a full year's worth of export sales as of 2014. Meanwhile, management are looking to achieve 20% per annum sales growth in the coming 5 years in the domestic market.

PORTFOLIO PERFORMANCE

Performance Summary (%)
Period ending 31.03.2015

	USD	GBP	SGD
1 Month	-2.04	-1.88	-2.13
3 Months	-0.91	-0.73	-0.87
Year to Date	-0.91	-0.73	-0.87
Since Launch+	58.14	61.48	16.16
2014	-3.49	-3.01	-3.43
2013	7.51	7.29	7.64
2012	30.80	31.05	30.69
Annualised 5 years	4.50	4.39	4.34
Annualised 3 years	6.28	6.57	6.41
Annualised Since Inception	6.62	6.94	2.92

Fund Performance - Class A USD (%)

Source: Bloomberg. Total return net of fees.

Source: Bloomberg
+ Launch date: A:08.02.08, C: 25.03.08, D: 15.01.10

Monthly Performance Summary (%)

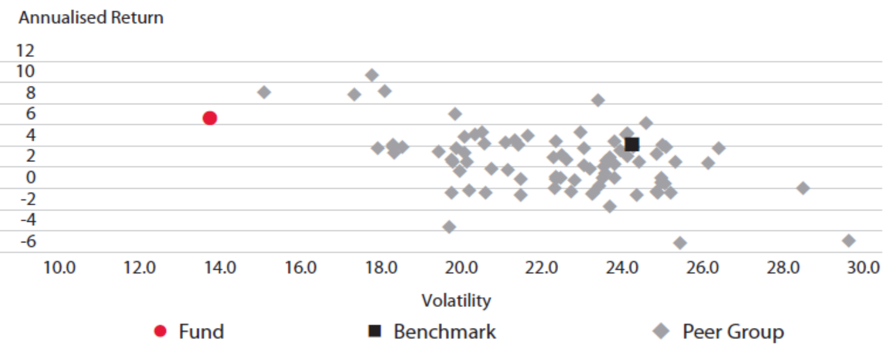
	Jan	Feb	Mar	Apr	May	June	July	Aug	Sept	Oct	Nov	Dec	Total
2015	1.25	-0.11	-2.04										
2014	0.21	3.58	-2.62	-2.50	0.56	2.45	-1.39	2.86	0.32	-1.85	-1.76	-3.11	-3.49
2013	7.27	3.73	1.32	1.82	3.58	-9.40	0.10	-4.52	3.54	2.84	-1.44	-0.51	7.51
2012	5.05	7.75	-1.04	4.29	-5.53	3.11	2.27	-0.65	5.40	1.27	4.12	1.81	30.80
2011	-2.15	0.43	2.35	3.75	-0.57	-1.22	3.60	-11.67	-8.27	0.37	-5.50	-1.07	-19.28

RISK ANALYSIS

Risk Metrics	Fund
Beta	0.54
Alpha (%)	4.3
Sharpe Ratio	0.48
Volatility (%)	14.0
% of the portfolio –which could be sold in 2 business days	34.00

Source: Bloomberg
Since Inception: A:08.02.08

Risk Adjusted Performance - Class A USD (%)



Source: Bloomberg. Annualised return and 1 year volatility versus the peer group (open ended offshore Asia Pacific ex Japan Equity Fund Index), 8.02.08 to 31.03.15

THEMATIC & GEOGRAPHICAL BREAKDOWN

Top 5 Holdings (%)

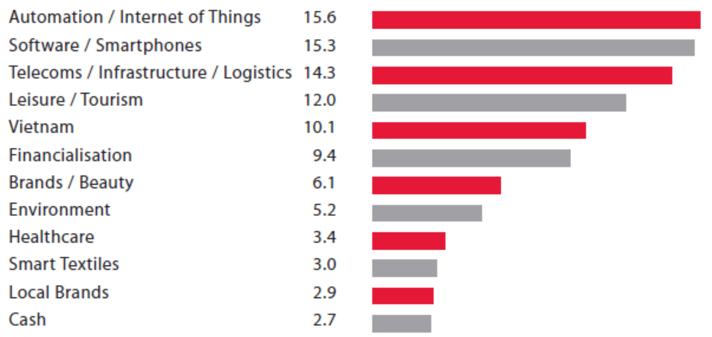
Innovalues	4.6
Waison Group	4.3
Ifast Corporation	3.9
Nexteer Automotive	3.6
Dat Xanh Real Estate	3.6
Total Number of Holdings	43

Portfolio Financial Ratios*

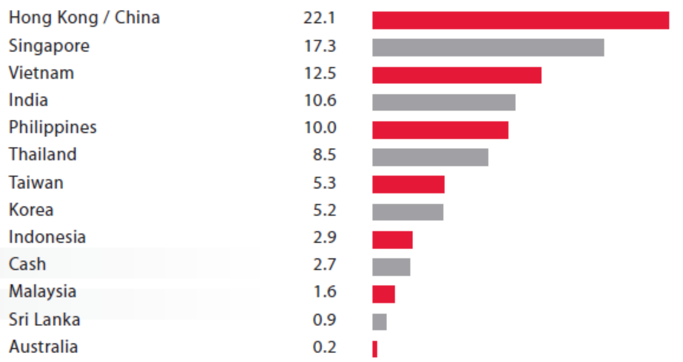
Predicted Price/Earnings Ratio	12.3x
Predicted Return on Equity (%)	21.2
Predicted Earnings Growth (%)	22.6

*Fiscal year periods

Thematic Breakdown (%)



Geographical Breakdown (%)



All data as at 31.03.15. Source: Prusik Investment Management LLP, unless otherwise stated.

FUND PARTICULARS

Fund Facts

Fund Size (USD)	141.5m
Launch Date	8 February 2008
Fund Structure	UCITS III
Domicile	Dublin
Currencies	USD (base), GBP, SGD

Management Fees

Annual Management Fee
1.5% p.a Paid monthly in arrears

Performance Fee
All classes except Class U: Provided the fund achieves an overall increase of 6% a yearly performance fee of 10% of the total returns will be applied.
Class U: Provided the fund achieves an overall increase of 1.5% per quarter, a performance fee of 10% of the total return will be applied.

Dealing

Dealing Line	+353 1 603 6490
Administrator	Brown Brothers Harriman (Dublin)
Dealing Frequency	Weekly, Friday
Min. Initial Subscription	USD 10,000
Subscription Notice	2 business days
Redemption Notice	2 business days

Share Class Details

Codes			SEDOL	ISIN	Month end NAV
Class 1					
A USD	Unhedged	Non Distributing	B2PKN21	IE00B2PKN210	158.14
B USD	Unhedged	Distributing	B2PKN32	IE00B2PKN327	158.29
C GBP	Hedged	Distributing	B2PKN43	IE00B2PKN434	82.92
D SGD	Hedged	Distributing	B3M3HJ5	IE00B3M3HJ55	217.75

Performance fee based on individual investor’s holding

U GBP	Unhedged	Distributing	BBQ37T7	IE00BBQ37T77	97.88

Performance fee based on fund performance as a whole
All share classes are closed to new investors as of 30th September 2013.

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