PRUSIK

LONG ONLY ABSOLUTE RETURN INVESTING IN ASIA

Prusik Asian Equity Income Fund

Quarterly Investment Report
30 March 2018

FOR PROFESSIONAL INVESTORS ONLY

Q1 2018 Review and Outlook

The fund fell by 2.6% in 1Q 2018 underperforming the index which fell by 0.7%. The biggest contributors to performance were **Gree Electric Appliances**, **Macquarie Korea Infrastructure Fund** and **Glow Energy**. The biggest detractors were **Zhejiang Expressway**, **Kangwon Land** and **Beijing Capital Airport**.

Why is PAEIF underperforming?

It is important to emphasise that we do not consider the index when constructing the portfolio – we are happy having zero exposure to any country or sector if we have no opinion on it even if that creates a significant tracking error. However, it is sometimes helpful to use the index to explain to our investors why we underperform. Our primary objective is to generate long-term absolute returns. However, we do think of the market return as being our "cost of capital" and in turn, believe we have a process that will outperform the market over time. This said, it may be helpful to look at why, since the end of June 2017, the market is up 14% but PAEIF is only up 5%. What explains this gap of 9%?

Reason #1. PAEIF is underweight cyclicals and overweight defensives

	June 2017 weightings		**March 2018 weightings**		**Sector Performance June 2017 to March 2018**	
	PAEIF	MXAPJ	PAEIF	MXAPJ		
Banks	7%	19%	4%	18%		12%
IT	8%	25%	6%	27%		22%
Resources	0%	11%	0%	11%		20%
Total Cyclical	**15%**	**54%**	**10%**	**56%**	**Average**	**18%**
Utilities	8%	4%	13%	3%		6%
Telecoms	5%	6%	10%	4%		-5%
Cash	7%	0%	4%	0%		1%
Total Defensive	**20%**	**10%**	**28%**	**6%**	**Average**	**1%**
PAEIF relative weighting vs MXAPJ	Jun-17	Mar-18				
Cyclicals	-39%	-46%				
Defensives	10%	21%				

Source-Prusik/Bloomberg

Because our strategy seeks out companies with high free cash flow generation, sustainable dividends and stable growth we tend to avoid companies with a high degree of cyclicality. This isn't because we think that cyclicals will always underperform but just that our strategy tends to work better on stocks where we don't need to have a view on the economy to decide how to value the company. As a result, we will almost always have a low weighting in the most cyclical sectors which we have defined as banks, technology and resources. The converse is also true: Because telecoms and in particular utilities often have stable cash flows and high margins, we tend to have an overweight position in these sections of the market.

It can be seen from the table above our limited exposure to "cyclical" sectors in Asia has proved costly from a relative performance perspective since the end of June 2017. Since that time, these sectors are up, on average, 18%. At the same time, we have a significant exposure to the more defensive sectors which are only up 1% over the same time period. Readers will also note that we have increased our exposure to defensives and reduced our exposure to cyclicals as relative valuations have changed over the last 9 months.

The chart below shows the relative Price to Book ratio for Defensives vs Cyclicals.

Source-Bloomberg

Reason #2. Underweight China and Exposure underperformance

Another striking feature of our performance since June 2017 is the underperformance of our China Portfolio during this period. Since then we have generated a 4% return compared to the market which is up 25% over the same time frame (to put this in context, over the past 3 years our China portfolio is up 92% compared to a 37% rise in the index). This is largely due to the poor performance of two of our biggest holdings – **Zhejiang Expressway** and **Beijing Capital Airport**. Compounding the issue, we have also been underweight China since June 2017 – averaging 17% for our fund compared to 25% for the index.

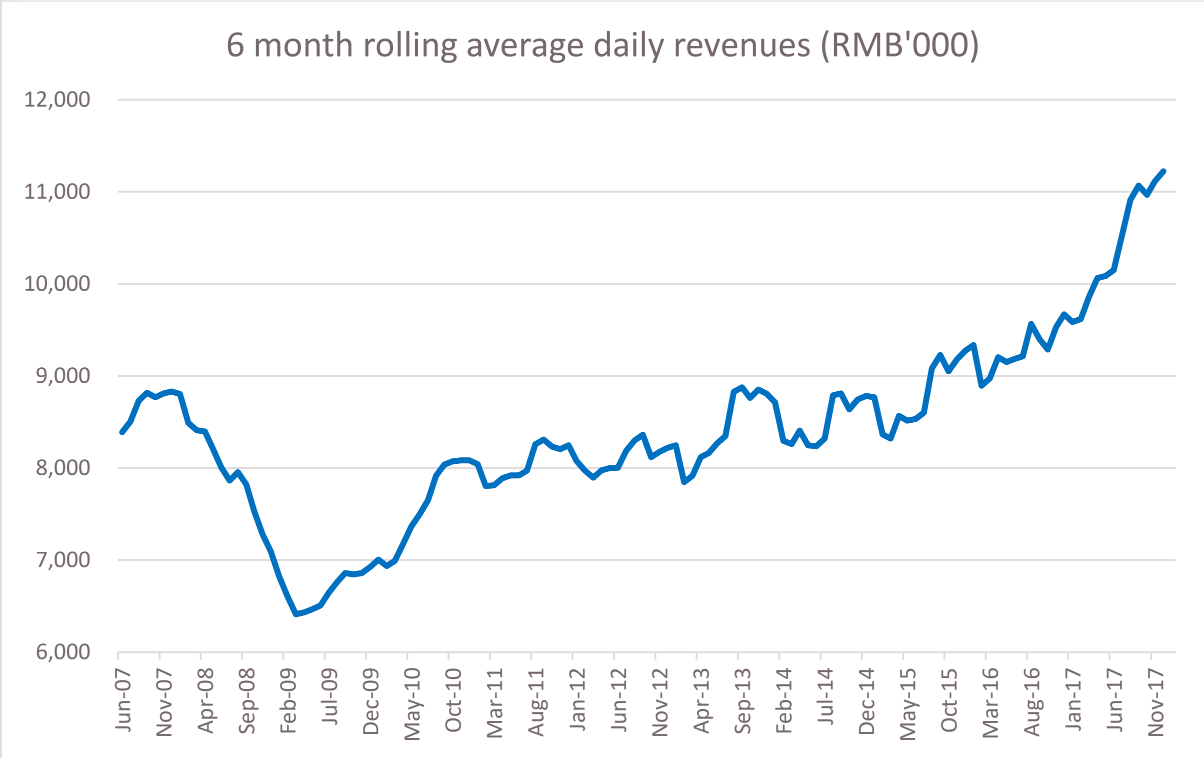
In the table below, we decompose the performance into the change in "fundamentals" (in this case, the forward earnings estimates) and "valuation" (the P/E estimate). It shows that even though earnings estimates have increased for both these stocks (in the case of **Beijing Airport** at a similar rate to the market), the stocks have performed poorly because they have suffered P/E *de-ratings* of 30% over this period compared to the market which has seen a stable P/E ratio.

	12-month forward EPS change since June 17	Price change since June 17	P/E change since June 17	Current P/E
Zhejiang Expressway	+6%	-22%	-31%	8.0x
Beijing Capital Airport	+25%	-4%	-29%	11.4x
MSCI China	+28%	+25%	-2%	12.4x

Source-Prusik/Bloomberg

Some comments on both of these stocks

- **Zhejiang Expressway** has a net cash balance sheet.
- The stock trades at HK$8/share. Its toll road has an 80% profit margin and produces approximately HK$1/share in free cash flow (for the remainder of the concession period) and it owns a stake in A-share listed Zheshang Securities worth HK$5/share.
- Stripping that out **implies the toll road is trading on 3x free cash flow (33% yield).**
- The toll road operation is growing at 5-10% a year. Below is a chart of 6 month rolling revenues from their main asset (Shanghai-Hangzhou-Ningbo section).



Source: Company website

- The current dividend yield is 6.2%. **The dividend has been maintained or increased in 19 of the last 20 years** (the worst cut was 3% in 2012). See chart below.

Source: Bloomberg

Why has the stock de-rated?

- Weakness in securities business which is 40% of profits although now part of a separately listed company.
  - The Company issued a convertible bond and is looking for acquisitions in Europe. The concern is that they will overpay.
  - Very little research coverage as investment banks trim research costs.
  - Fears that government want to reduce "logistics costs" (ie. Reduce toll road tariffs).
  - The opening of a competing road from Ningbo to Hangzhou (a government project to open an "EV only" road).
- We believe that these concerns are discounted in the current share price and that the risk/return at these levels is extremely attractive.

Beijing Capital Airport

- **Beijing Capital Airport** has a market cap of US$5.8bn and US$300m of net debt.
- It produces almost US$1bn of EBITDA and free cash flow to equity holders of US$500m a year, implying the stock is valued at almost a 10% free cash flow yield and 6x EV/EBITDA.
- AOT, Sydney Airport and Auckland International Airport trade at 18-22x EV/EBITDA and private transactions occur at even higher multiples.
- At a 15x EV/EBITDA, the stock would be valued at a 140% premium to the current share price.
- Concerns are largely around the opening of the second airport in Beijing, in late 2019, which will likely take traffic away from BCIA in 2020. We believe that the market is too bearish about this as BCIA is already trying to shift lower margin domestic flights to other airports, in order to increase the % of international flights which have higher margins and higher non-aero revenue.
- **We believe the market price implies that the company will have negative cash flow growth from this point onwards which appears too bearish given the potential growth in Chinese travel over the next decade.**

New Positions

IRB Invit Fund

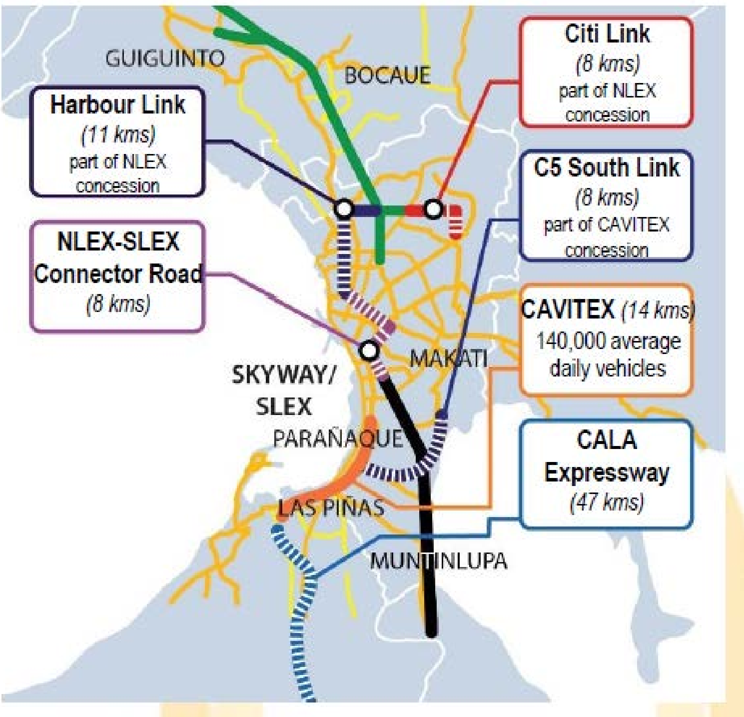
This is a trust of Indian toll roads that was listed by the sponsor, IRB Infrastructure, last year. We declined to participate at the time of the IPO as the equity IRR offered was not attractive enough and our experience is that these infrastructure trusts often perform poorly at IPO, as they are often poorly understood by the market in the early days because they are more similar to bonds than they are to equities. In brief, the sponsor sells cash-flow producing infrastructure assets (in this case toll roads) into a trust which then pays out those cash-flows (it is required by law to pay out a minimum of 90% of the cash-flows as dividends) to investors. Because the assets are generally very predictable, they are more similar to structured credits rather than equities and so the equity market is often ill equipped to analyse them as they have finite lives, (the length of the concession period), and so need to be valued on a discounted cash-flow basis.

Following the IPO the stock did perform poorly, partly because a stable, high yield company is not attractive to retail and institutional investors during an equity bull market and partly because the high minimum lot size (US$7,000) means that it is off limits to many Indian retail investors. In addition, there is very little sell side coverage of the stock which has a market capitalisation of just US$750m.

The investment case is relatively simple: The trust owns seven toll road projects with an average residual concession period of 17 years. The traffic growth on average is expected to be 5-6% a year and the company has a (partially) inflation protected toll rate agreement which allows tariffs to be increased by "3% + 40% of WPI" per year. In other words, if WPI (wholesale price inflation) is 6% then the company can increase tolls by 5.4% (3% + 40% of 6% = 5.4%). The cash flows are then forecast over the remaining concession period and an equity IRR is calculated. At the time of writing, we calculate that IRR to be approximately 15%. **The company pays a dividend of INR3/quarter which translates into a dividend yield of 14%.** Finally, because of the introduction of capital gains tax in India, it is worth noting that the tax treatment of our (potential) return from this investment is now more attractive as the withholding tax on our returns is likely to be around 2% (depending on the structuring of the returns to investors between capital, interest and dividends), as opposed to 10% capital gains tax.

Metro Pacific Investments

Metro Pacific (MPI) is a Philippine Infrastructure Operator with exposure to the power, toll road and water sector in the Philippines. The company owns a number of key assets including Meralco (the largest electricity distributor in the Philippines), Maynilad Water Services (the second largest water company in the Philippines) and Metro Pacific Tollways (the largest toll road operator in the Philippines). Metro Pacific Tollways Corp owns a number of toll roads in Metro Manila and nearby provinces.



Source: Company presentation

Why has the stock been weak?

The company has been in arbitration with the government over a dispute over tariffs for the Maynilad water business since 2013. In July 2017, an Arbitration tribunal in Singapore ordered the Government to reimburse Maynilad PHP3.4bn for losses from March 2015 to August 2016. In February 2018, the Government filed an application with the High Court of Singapore to set aside the arbitration ruling. Maynilad is set to challenge this application. Even though the dispute is only a "low single digit" % of NAV, the stock fell 10% on the news. This is because the government is also in dispute with the company over their toll road hikes and the concern is that the company will not be allowed to increase tariffs across its entire business in line with the concession agreement.

With regards to the toll roads, the company wants to increase tolls by 12-14% per year from 2018-2022 to recover lost revenues. However, the Department of Transport wants this recovery to take place over the life of the concession. **I believe the company is willing to negotiate with the government with regards to any settlement and, given that, the market is so negative on any chance of recovering these losses, I believe the market will take any settlement very positively.** There is no doubt that the optimism generated by the government from its desire to improve and roll out infrastructure has almost completely vanished. However, the need for that infrastructure has not gone away and I believe **Metro Pacific** is in an excellent position to benefit from the long-term potential that is undoubtedly there.

Valuation

The NAV for the stock is approximately PHP10/share and so the stock at PHP 5.5, is currently trading at a 45% discount to that level. I believe that the stock should trade at closer to a 20% discount to NAV (approx. PHP8/share), although it could be argued that the discount should be even narrower given the growth potential and optionality in the company. Even if we assume the toll road and Water businesses are worthless, the NAV is still PHP5/share. If we assume that they can get no tariff increases, the NAV is approximately PHP7.00/share. The company should be able to grow the NAV by 5% a year by adding new projects (in addition to the growth of NAV due to the discount rate). The dividend yield of the company is not particularly high, (1.9%), as the company is reinvesting cash-flow back into the business (which to me is a better use of cash than paying it back to shareholders). The P/E of the stock, at 12.6x, is low both relative to other stocks in Asia and also its own history.

Singapore Exchange

Singapore Stock Exchange (SGX) is a monopoly which operates both the equity and derivatives market (SIMEX) in Singapore. Growth is improving after 5 years due to both a recovery in the domestic stock market combined with continued strong growth in the derivates market.

The business is very attractive due to:

- **Monopoly status** = high margins (40% net margins and 30% ROIC).
- **High Barriers to entry** due to the network effect of exchanges (and a regulatory regime which no longer wants to see multiple exchanges).
- Revenue should grow faster than nominal GDP due to increased listings over time and the largely fixed nature of its costs.
- Upside optionality from new derivatives products (e.g. Indian Single Stock Futures could add 5-7% to earnings if introduced as expected).
- Limited capital requirements mean that it can grow at 10-15% whilst paying out 90% of its earnings as dividends
- Net cash balance sheet.

Swire Pacific

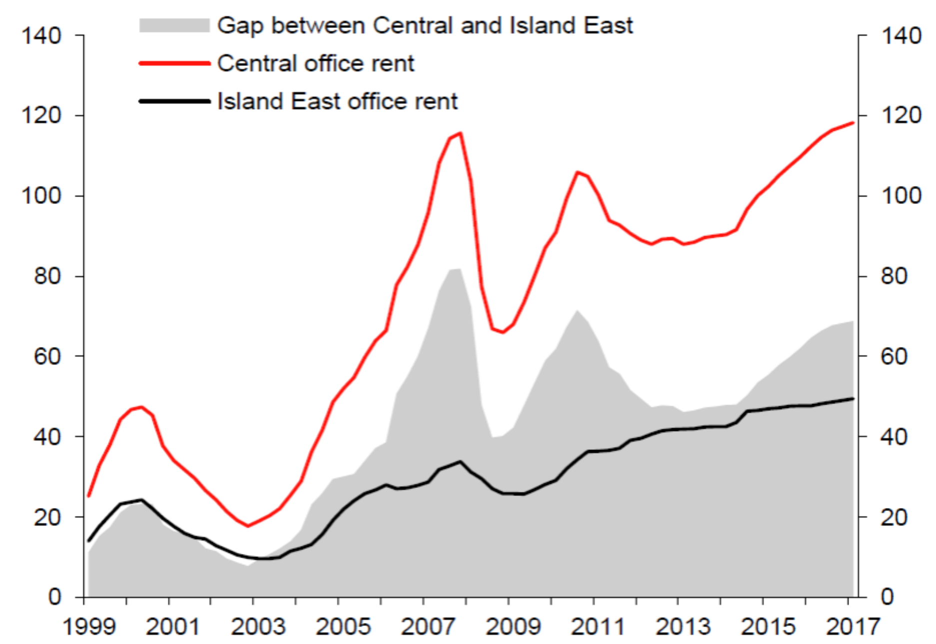
Swire Pacific is a conservatively managed portfolio of assets that includes some very high-quality businesses (Swire Properties), some high growth businesses (e.g. Swire Beverages) and some low quality cyclical businesses (Marine Services, Aviation)**. The investment thesis is that the market is overly focused on the low quality cyclical businesses (which are a small part of the overall valuation but a large part of the current profit downturn) and ignores the strength of the larger businesses which are performing strongly and are of very high quality**. Even if these cyclical businesses do not recover, I believe that stock is very undervalued given the strong growth from the real estate and beverage business.

The Price to book ratio is at an all-time low – only seen during the Asia crisis in 1997 and the GFC in 2008. The stock is trading at just 50% of the book value of the assets – which I believe understates the true valuation of the business. Very few sell side firms research the stock anymore as it is possibly the least fashionable stock in Hong Kong – those that do are negative on it having been battered and bruised by 2 years of constant downgrades and a cut in the dividend. I believe there is 50% upside in the stock to fair value and minimal downside even if I am wrong (as discount already implying a significant deterioration in business).

Investment Case

Swire Pacific is one of Asia's oldest companies and has been operating in China since 1861. Today the company is involved in a large number of industries including real estate, aviation and shipping. Their main asset is an 82% stake in Swire Properties which owns many key office and retail assets in Hong Kong, including Pacific Place and 1 Taikoo Place. Pacific Place shopping mall is a tier 1 asset with a long waiting list of tenants. The office block is also well located and benefiting from a tight supply/demand situation in Central, driven by demand for space by Chinese corporates. Island East, where 1 Taikoo Place is located, has the potential to take tenants from Central as rents are 1/3 of the level and improving infrastructure, (including a bypass which will commence in late 2018), will reduce the rush hour commute from 22 minutes to 10 minutes.

Fig 2 Office rent gap between Central and Island East



Source: Macquarie Securities

Swire Pacific are seeing tenants that normally would only consider Central moving into their property (e.g. Baker and McKenzie, Facebook, BNP, WeWork). The opening of Shanghai HKRI Taikoo Hui will further boost profits this year as the property ramps up. They also own a 45% stake in Cathay Pacific which has been negatively affected by structural and cyclical factors but it has now managed to cut costs and remains a premium airline brand.

The only other business of any significance is Swire Beverages which manufactures and distributes Coca Cola in Hong Kong, China and the USA. This business has an ROE in the mid-teens and the potential to grow in the high single-digit rate for many years to come. It also has the potential to become a bigger part of the NAV than Beverages given the franchise population size is 660m people (mainly China).

Analysts spend a lot of time on Haeco (aircraft maintenance) and Marine services (providing support vessels to the energy industry for offshore production) as they have been going through tough times but they are just simply irrelevant with regards to the overall profits for the company. However, to the extent that expectations are extremely low, there is the potential for upside if either recover - (can be thought of as free call options).

Valuation

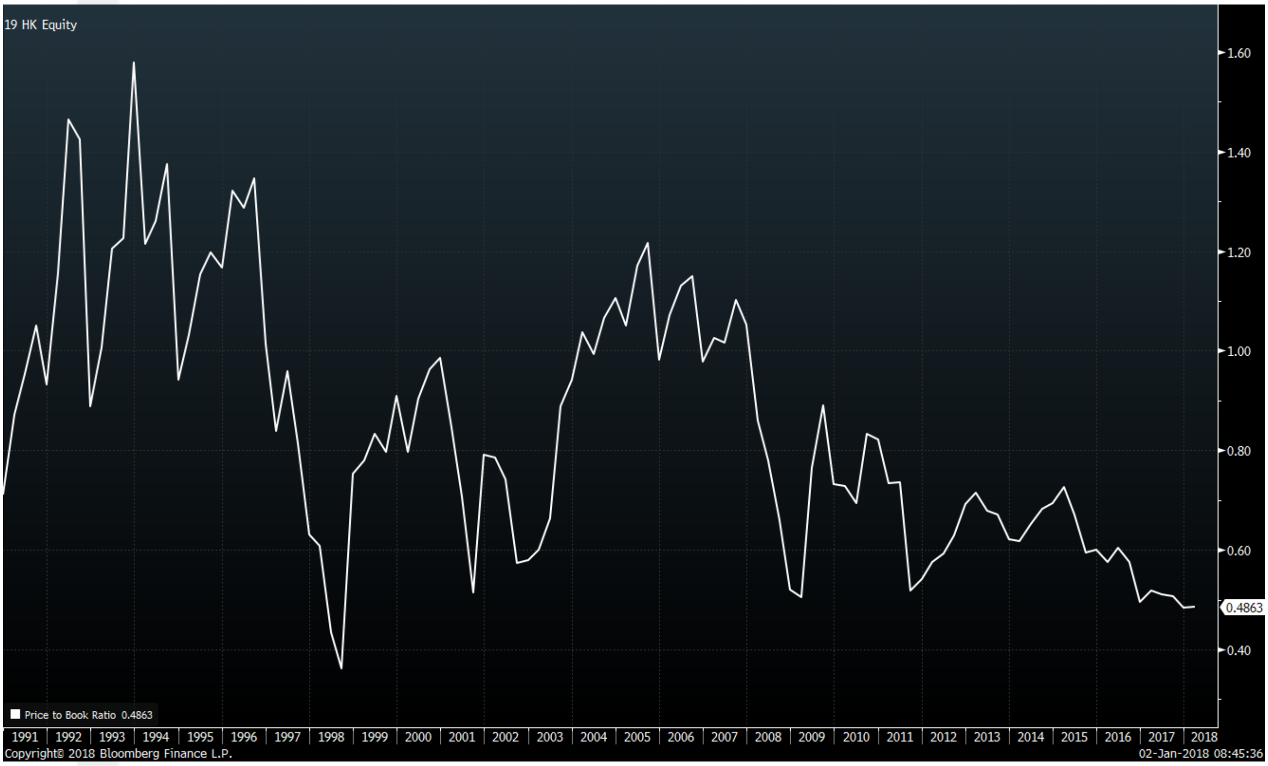
- P/B at all-time lows (only seen during Asia Crisis and 2008).
- After cutting the dividend from HK$4/share to HK$2.20/share in 2017, I expect the dividend to be HK$2.50/share in 2018 and HK$3.25/share in 2019, **placing the B-shares on a 5%+ yield in 2019 with upside potential should there be a recovery in the aviation or marine sector.**
- Table below gives the valuation breakdown.

	Stake	Valuation	% of total
Swire Properties	82%	191,880	8S%
Cathay Pacific	45%	24,783	11%
Haeco	75%	6,237	3%
Beverages		20,000	9%
Marine Services		5,000	2%
Trading & Industrial		2,000	1%
Net Debt		18,160	
Total		225,503	
Number of shares		1,505	
NAV/Share		150	
Discount to NAV		-51%	
Target discount		-30%	
Implied Price		105	
Upside		44%	

Source: Bloomberg

- **I believe that the current discount to NAV is excessive** (especially considering that the NAV for Swire Properties is 25% higher than the book value (which I used in calculation above)).
- **The current valuation implies financial distress which appears unlikely given the low level of debt and conservative nature of the group.**
- The company is currently buying back shares which is very accretive to valuation given the discount.

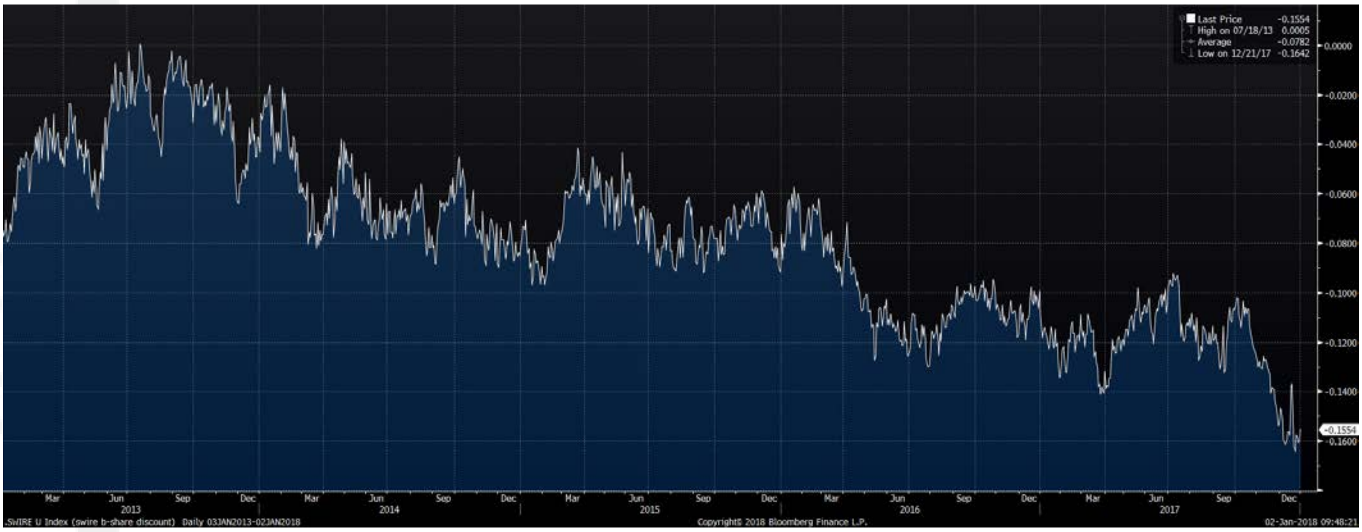
Price to Book Chart



Source- Bloomberg

B-share discount

- Swire Pacific B-share discount has widened out to near 16% (see chart below).
- B-shares have the same economic rights as the common shares but 5x the voting rights and I believe are the shares to focus on.
- I believe the B-shares are more attractive given the voting rights and discount.



Source-Bloomberg

Exited Positions

Fortune REIT

Although we believe that the gap between private and public valuations for Fortune REIT provides considerable support for the stock, the valuation in absolute terms leaves little room for disappointment and we have decided to exit our (small) position in the stock.

KT&G

We have decided to exit the position as the fundamentals are continuing to weaken as the company loses market share in both traditional and new (e-cigarette) markets.

Nagacorp

The stock reached our price target after announcing strong results.

Wuliangye Yibin

Although the business fundamentals remain strong and the earnings and price momentum are robust, the valuation (at 27x P/E) means that the downside risk is substantial if the business conditions weaken.

Gree Electric Appliances

The valuation remains optically attractive but the cyclical tailwinds that have supported the stock are fading (cooling property market) and the margins are unsustainably high. The company is still determined to expand outside the core air conditioning market (e.g. into mobile phones) which we think is worrying.

PORTFOLIO PERFORMANCE

Performance Summary (%)
Period ending 30.03.2018

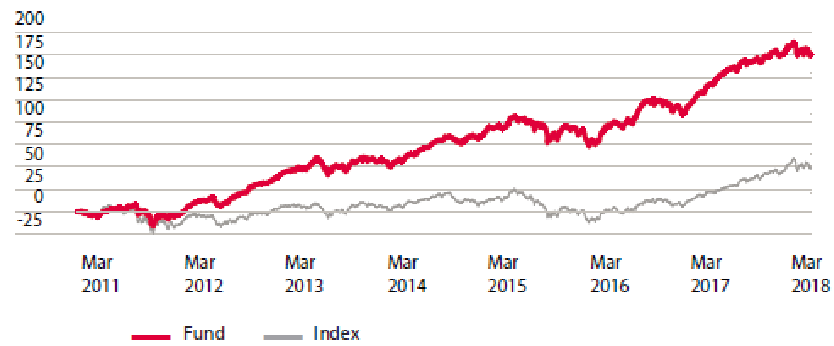
Class 1*	B USD	Benchmark **
1 Month	-1.26	-2.21
3 Months	-2.59	-0.56
YTD	-2.59	-0.56
2017	32.79	37.32
2016	10.36	7.06
2015	3.17	-9.12
2014	16.79	3.09
2013	13.45	3.65
Since Launch+	173.16	47.32
Annualised since Inception	14.87	5.49

* Class 1 shares were closed to further investment on 30th November 2012

**MSCI Asia Pacific ex Japan

+ Launch date: B 31.12.2010

Fund Performance – Class B (USD) (%)



Source: Morningstar. Total return net income reinvested.

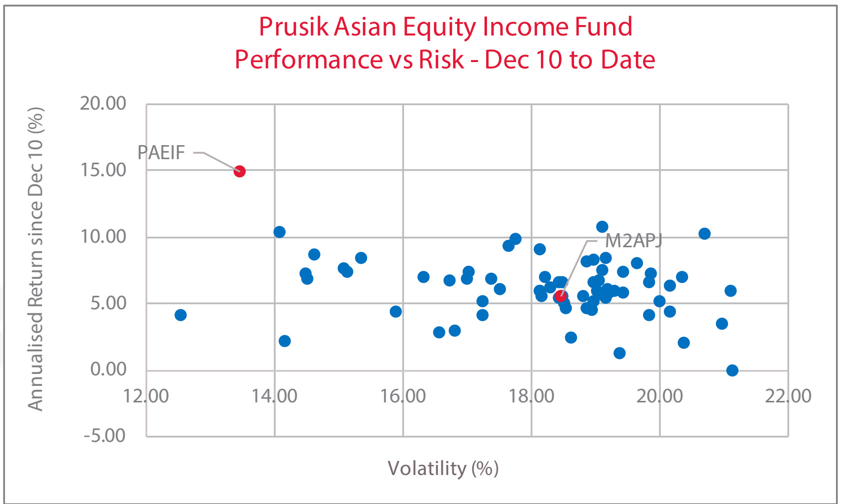
Class 1 B, USD Monthly Performance Summary (%)

	Jan	Feb	Mar	Apr	May	June	July	Aug	Sept	Oct	Nov	Dec	Total
2018	2.51	-3.76	-1.26										-2.59
2017	5.49	4.77	3.98	2.69	3.25	1.11	2.71	0.06	-0.54	2.91	0.85	1.61	32.79
2016	-6.04	-0.37	10.28	0.95	-0.38	2.46	7.56	1.20	0.54	-1.43	-0.68	-3.16	10.36
2015	4.35	1.41	-0.70	6.01	-1.69	-1.97	-1.63	-6.01	-0.70	7.04	-1.91	-0.33	3.17
2014	-4.34	4.03	1.50	1.58	4.63	2.14	3.50	1.24	-2.54	2.31	2.00	-0.05	16.79
2013	3.93	1.78	0.35	4.57	-0.53	-4.95	1.87	-2.24	5.07	4.15	-0.56	-0.25	13.45
2012	8.12	6.54	1.92	3.20	-7.67	3.84	6.72	1.92	6.36	1.97	2.76	3.63	45.77
2011	-2.68	-1.46	2.55	3.90	2.58	-0.60	3.56	-6.06	-12.80	10.62	-3.52	1.79	-3.96

RISK ANALYSIS

Risk Metrics	Fund (%)
Tracking Error (% pa)	9.42
Beta	0.77
Alpha (%)	9.84
Volatility (%)	13.46

Source: Morningstar
Since inception: B 31.12.2010



Source: Morningstar

THEMATIC & GEOGRAPHICAL BREAKDOWN

Top 5 Holdings (%)

CK Hutchison Holdings Ltd	6.0
Samsung Electronics	5.8
Beijing Capital International Airport	4.9
Zhejiang Expressway	4.8
AIA Group Ltd	4.7
Total Number of Holdings	35

Portfolio Financial Ratios

Predicted Price/Earnings Ratio	12.3x
Predicted Return on Equity (%)	14.2%
Predicted Dividend Yield (%)	5.0%

Thematic Breakdown (%)

Transport Infrastructure	26.6
Power Utilities	15.6
Communications Infrastructure	15.5
Financials	10.7
Real Estate	7.9
Consumer	7.8
Cheung Kong / Hutchison	6.0
Technology	5.8
Cash	4.1

Geographical Breakdown (%)

Hong Kong	24.2
China	15.7
Korea	11.4
India	10.3
Thailand	8.8
Australia	7.8
New Zealand	7.2
Indonesia	4.1
Cash	4.1
Singapore	2.6
Philippines	2.4
Pakistan	1.7

All data as at 30.03.2018. Source Prusik Investment Management LLP, unless otherwise stated.

FUND PARTICULARS

Fund Facts

Fund Size USD	994.2m
Launch Date	31st December 2010
Fund Structure	UCITS III
Domicile	Dublin
Currencies	USD (base), GDP, SGD

Management Fees

Annual Management Fee

1% p.a paid monthly in arrears

Performance Fee

Class 1: None
Class 2 and Class U: 10% of the net out-performance of the MSCI Asia Pacific ex Japan Index (MXAPJ) with a high-water mark.

Temporary Front End Charge: 3% introduced on 2nd December 2013 paid to the benefit of the fund.

Dealing

Dealing Line	+353 1 603 6490
Administrator	Brown Brothers Harriman (Dublin)
Dealing Frequency	Daily
Valuation Point	11am UK time
Dealing Cut - off	5pm UK time
Min. Initial Subscription	USD 10,000
Min. Subsequent Subscription	USD 5,000

Share Class Details

Class 1*			SEDOL	ISIN	Month end NAV
A USD	Unhedged	Non Distributing	B4MK5Q6	IE00B4MK5Q67	281.00
B USD	Unhedged	Distributing	B4QVD94	IE00B4QVD949	205.73
C GBP	Hedged	Distributing	B4Q6DB1	IE00B4Q6DB12	202.91
D SGD	Hedged	Distributing	B4NFJT1	IE00B4NFJT16	197.51

*Class 1 shares were closed to further investment on 30th November 2012.

Class 2*			SEDOL	ISIN	Month end NAV
X USD	Unhedged	Distributing	B4PYCL9	IE00B4PYCL99	183.79
Y GBP	Hedged	Distributing	B4TRL17	IE00B4TRL175	182.02
Z SGD	Hedged	Distributing	B6WDYZ1	IE00B6WDYZ18	183.35

*Class 2 shares were soft closed to new investors as of 30th November 2012. Performance fee based on individual investor's holding

Class U*			SEDOL	ISIN	Month end NAV
U GBP	Unhedged	Distributing	BBP6LK6	IE00BBP6LK66	164.64

*Class U shares are open to current investors only. Performance fee based on fund performance as a whole

Dividend Dates

Dividends paid twice annually (January and July)

Fund Manager

Tom Naughton
Tel: +44 (0)20 7493 1331
Email: tom.naughton@prusikim.com

Sales & Marketing

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

Michelle Johnson
Tel: +44 (0)20 7297 6858
Fax: +44 (0)20 7493 1770
Email: michelle.johnson@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