PRUSIK

Long Only Absolute Return Investing in Asia

Prusik Asian Equity Income Fund

Quarterly Investment Report
31 March 2015

FOR PROFESSIONAL INVESTORS ONLY

THOMSON REUTERS
LIPPER FUND AWARDS 2015
UNITED KINGDOM

Q1 2015 Review & Outlook

In the first quarter, the fund returned 5.1% compared to a market return of 4.5%, thus marginally outperforming the benchmark.

The Hong Kong portfolio produced the bulk of both the raw performance and alpha for the quarter. Accounting for around 23% of the NAV, it produced almost 60% of the profit for the quarter with **Hutchison/Cheung Kong** accounting for a significant portion of the returns. We continue to maintain a large position in these two names with the expectation that the proposed restructuring of the group will lead to both higher valuations and a higher dividend payout ratio. Elsewhere, our holdings in **Beijing Capital Airport, Bangkok Expressway, MTR Corp, Indiabulls** and **Macquarie Korea Infrastructure Fund** all produced returns above 15%.

In terms of losing positions, we had 5 positions that fell more than 10% during the quarter (**Premium Leisure**, **Huaneng Power**, **Hyundai Motor**, **United Bank** and **PCCW**). Recall that **PCCW's** main asset is its holding in **Hong Kong Telecom** which is the dominant telecom and cable TV operator. However, it also operates in the IT solutions and media business. Although **PCCW** management's expertise in the former is relatively easy to understand and quantify, their desire to build a regional Asian new media business (developing and distributing content via the internet) is more worrisome, with reports in the media that they are planning to bid for **Dailymotion** – a distant competitor to **YouTube**. They are still committed to paying out 70% of the dividends received from **HK Telecom** which underpins a 5%+ dividend yield this year, but the market will not take kindly to the announcement of the remaining cash flow going into value destructive investments.

Premium Leisure performed very poorly during the quarter falling by 31% and giving back all the gains of last quarter. This was partially due to concerns that the corruption crack-down in China would affect its VIP business and partially due to the fact that casino stocks often trade strongly during the pre-launch phase and then fall back once the casino actually opens. Chinese visitors account for only 15% of total revenues (compared to 70% for Macau casinos) and so the impact here is muted. Also, more junket operators are setting up in Manila to avoid the scrutiny that visits to Macau generate.

Although the pace of the ramp up might be somewhat slower than the market had anticipated, we still believe that this debt free company will generate a yield of 6-7% in 2015 increasing to 10% once the casino is fully ramped up in 2016/17. We had trimmed the position near the highs of last year and have taken advantage of the weakness to buy back into the stock.

Credit Quality

We are concerned about the deterioration in credit quality due to several factors:

- The strength of the US dollar
- The deflationary backdrop
- Slowing economic growth

Studying the balance sheets of the Chinese real estate developers is not for the faint hearted. Although still touted by many as being attractive stocks due to their low price to earnings ratios and high dividend yields, our interpretation is somewhat different. **Evergrande** seems optically to be an extremely attractive stock. Paying an 11% dividend yield, trading on a P/E of 6.2x earnings, return on equity of 25% and a track record of strong earnings growth, it has many of the characteristics that we look for in a company. So what's the catch? The answer requires us to do a little more digging into the financials of the company.

Evergrande cannot be accused of not seizing the opportunity in the property market in China. Since listing in 2009 it has grown assets from US$9bn to US$76bn. It is now the third largest property company in the world as measured by asset size. By way of comparison, **Sun Hung Kai Properties** (ranked fourth) has a similar asset size but a market capitalisation of US$44bn.

Below we list some financial information for **Evergrande**

	2009	**2014**	**Growth rate (annualised)**
Total assets (USDbn)	9.2	76.4	52%
Interest bearing debt (including preference shares)	2.0	33.7	75%
Shareholders' equity (excluding preference shares)	4.8	9.6	11%
Market capitalisation	8.3	7.4	-2%
Debt to market cap ratio	24%	456%	
Market cap as % of total assets	90%	10%	

Source: Bloomberg

What is striking about the table above is that even though the company has grown assets at an annual clip of more than 50% and borrowings by 75%, it actually has a smaller market capitalisation now than it did at listing. **As a result, the asset base is now more than 10 times the size of the market cap**. So when viewing the company from the entire capital structure perspective, it could be argued that the shareholders are a mere bit part actor. There are many claimants on these assets: customers who have paid deposits for properties, the Chinese tax department, local governments, suppliers (often government controlled), joint venture partners, local banks, local bondholders, offshore bond holders and preference shareholders. 90% of these claimants on these assets rank higher than equity shareholders! So going into a deflationary downturn in the property market with no cash-flow, what might be a prudent strategy in these circumstances? A massive rights issue? A reduction of land purchases to improve cash flow? All quite sensible but the company's approach has been to continue to grow its land bank and, at the same time, expand into the "bottled water, grain and oil, dairy and health" businesses. In addition, in contrast to other property companies with stretched balance sheets, management have decided to pay substantial dividends – even though they have huge cash outflows from their operating businesses.

Why are we mentioning all this? We are mentioning this because **Evergrande** is not the only company in China that looks like this. Over the past 5 years there are many other developers that have seen their balance sheets evolve in a similar fashion (although admittedly none quite as impressive as **Evergrande's**). Moreover, many of these have significant foreign borrowings which will get more difficult to repay. If defaults increase then this may pressure further economic growth in the region as well as risk tolerance. We are not saying that all these companies will default; however, we do think risk levels have increased. Corporate credit quality has deteriorated substantially across the board and it may well begin to cause problems for debt holders and banks in the coming years. Given that a substantial portion of this debt is in US dollars then the strength of the US dollar will exacerbate this problem. At the same time, the slowing economy and deflationary price trend will constrain corporate cash flows. We are spending more time than ever studying the credit risk of our holdings to minimise the threat to the portfolio should the debt markets turn down.

Fortune REIT

Two of the questions we are often asked are;

- What do you think will happen to interest rates?
- What would be the impact on your fund of an increase in interest rates/bond yields

Our answers to these questions are interlinked and have an important impact on how we shape the portfolio and pick stocks. Breaking this down, we do not have a strong view on what will happen to interest rates. Both the "ice" theory where we never exit QE and rates stay near zero for the next decade and the "fire" theory where rates move sharply higher as the global economy recovers seem possible. In turn, our approach to stocks with high interest rate sensitivity (e.g. REITs) is generally to try and find stocks that have high potential upside in the first scenario but limited downside in the second. By doing this, not only do we hopefully maximise the "probability adjusted return", but it also removes the need for us to forecast interest rates.

A good stock to explain how this approach works is **Fortune REIT**. Regular readers will recall that **Fortune REIT** is a Hong Kong based retail shopping mall operator that owns a number of malls in the suburbs of Hong Kong. Its tenants supply day to day necessities – supermarkets, fast food outlets and convenience stores and are often the only shopping destination for the tenants that live nearby. It has a market capitalisation of HK$15.2bn, net debt of HK$10.4bn and generates net property income of HK$1.2bn. So we calculate the net property yield to be 4.7%[1].

Typically, retail mall transactions are priced at either a 200bps premium to conventional bonds or 400bps over index-linked bonds. The current yield on the Hong Kong 10 year bond is 1.5%. We assume future inflation of 2.5%[2]. This implies real interest rates are -1%. Using the first measure would give a "fair" implied yield of 3.5% and using the second would give a "fair" implied yield of

[1] We calculate the yield in this way to strip out the impact of leverage and analyse the income stream at the asset level.
[2] We arrive at the estimate using the following logic:

- Hong Kong CPI is forecast to be 3.5% in 2015 and 2016.
- Over the past 10 and 20 years it has averaged 3.1% and 1.9%, respectively.
- In the short term it appears as though an estimate of 3-3.5% would be appropriate but, over a 10 year view, a lower figure seems prudent.
- We assume 2.5% as our inflation forecast.

3.0%. As a reality check **Fortune REIT** has recently sold a non-core property to an independent third party at an implied yield of 2.9%. All of this suggests that a private buyer would pay somewhere in the region of 3-3.5% for the properties assuming interest rates stay where they are.

The table below looks at various scenarios for nominal and real interest rates to analyse what the valuation of the company would be in certain interest rate scenarios. The “Upside” column assumes that the shift in rates occurs immediately. We have also added a “3 year return” column, which assumes that the net property income grows by 5% per year (down from a 10-15% historic growth rate) and includes the dividends received over that period. The striking conclusion is that even if real rates rise to 200bps in the next 3 years (from the current level of -100bps) then we could still expect positive total returns over that period.

10 year (nominal)	10 year (real)	Cap rate	Implied Price	Upside	3 year return
0.0%	-2.0%	2.0%	26.45	227%	308%
0.5%	-1.5%	2.5%	20.05	148%	216%
1.0%	-1.0%	3.0%	15.78	95%	155%
1.5%	-0.5%	3.5%	12.73	58%	111%
2.0%	0.0%	4.0%	10.44	29%	79%
2.5%	0.5%	4.5%	8.66	7%	53%
3.0%	1.0%	5.0%	7.24	-10%	33%
3.5%	1.5%	5.5%	6.07	-25%	16%
4.0%	2.0%	6.0%	5.10	-37%	2%
4.5%	2.5%	6.5%	4.28	-47%	-10%
5.0%	3.0%	7.0%	3.58	-56%	-20%

Source : Bloomberg, Thomson Reuters and Prusik Investment Management

What this shows is the relatively attractive risk/return profile of an investment in **Fortune REIT**. If rates stay where they are then our fair value is between 58% and 95% higher than the stock price. If rates increase by 100bps then we still should earn a 53% return over the next 3 years. And if rates go to zero then our upside potential is more than 300% over 3 years. For us to suffer any significant long term loss over the 3 year period, 10 year nominal rates would need to reach 4.5%.

The usual caveats apply. The numbers above are not meant to be construed as a forecast, but rather to highlight a framework for thinking about the risk/return characteristics of the investment. The above assumes that the market will ultimately value **Fortune REIT** “correctly”, but the market may not agree with our valuation model or rents may fall and so on. We have to then do due diligence on determining whether our rental growth rate assumptions are correct, what the impact of higher rates would be on the cost and availability of debt, discuss with the REIT manager[3] the prospects for accretive asset enhancement possibilities and monitor the impact of ecommerce on the shopping mall industry in Hong Kong and so on.

[3] ARA – which we are also invested in

Positions Exited

We exited a number of positions during the quarter. Approximately half of these were for “good” reasons (they reached our target price) and half of them were because either we had made a mistake in buying them in the first place or we felt that the investment case had changed since purchasing. The net effect has been an increase in the credit quality and decrease in the cyclicality of the fund.

Bangkok Expressway

- Reached our target price after announcing merger with mass transit operator **Bangkok Metro**. We like the strategic nature of the deal, but the merger terms are not favourable to **Bangkok Expressway** and so it reduces our valuation.

Power Assets & Cheung Kong Infrastructure

- Both of these companies, part of the same group, reached our target price as investors bid up the price of utility stocks at the beginning of the year.

Pact Group

- As already discussed in the February fact sheet, we exited this position after the stock reached our target price.

Zhejiang Expressway

- The stock price reached our target price partly due to the announcement that the company was planning to list its securities business on the A-share market (yes, we agree it’s unusual for a toll road company to own a securities business).

Huaneng Power

- Although still cheap we have exited this position as we believe that the risk of a profit squeeze is underestimated by the market. As we come towards the end of the collapse in coal prices, the company faces the prospect of rising fuel costs combined with tariff cuts. Combined with a highly geared balance sheet and sensitivity to a devaluation in the Remnimbi, we no longer feel the risk/reward is favourable.

Anhui Expressway

- The stock had approached our target price. As an illiquid holding with exposure to the more cyclical region of Anhui, we have exited our position to improve overall portfolio liquidity.

Korea Electric Power

- The reasons for exiting were similar to those of **Huaneng Power**. The company faces the prospect of fuel costs that are no longer falling combined with pressure on tariffs which, when combined with the high level of gearing, make for a less attractive risk/return prospect. The company is very exposed to a weaker Korean Won.

Hyundai Motor Preference Shares

- As noted in the January factsheet, our patience with this company was wearing thin and we have decided to exit the position. A combination of a weaker Japanese Yen (and now Euro) versus the Korean Won is not only pressuring the current profitability of the company, but also presents longer term challenges for the company. Given the huge investment in technology that is now required for companies to address the increased automation of vehicles, the European and Japanese manufacturers are now able to reinvest the windfall profits of weaker exchange rates in R&D in a way that **Hyundai** is not. The valuation argument remains intact, but the strategic challenges mean that the risk/reward no longer seems attractive.

Berjaya Sports Toto and **Magnum**

- Although arguably a year too late, we are finally exiting these two Malaysian lottery positions following a review of their competitive positions.

There were no new positions of any significant size in the quarter.

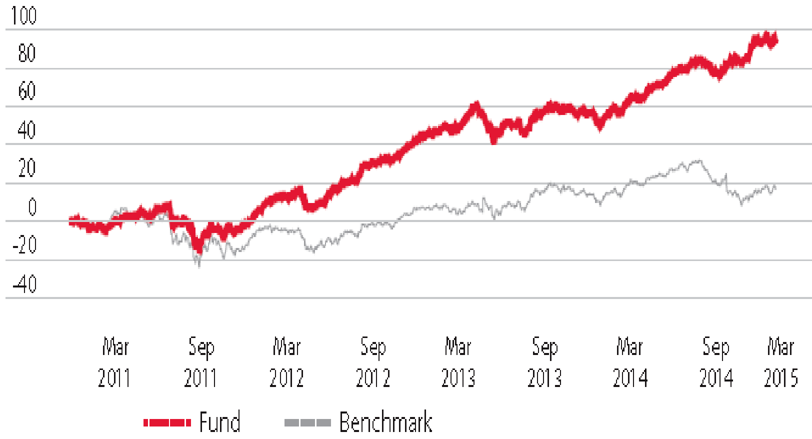
PORTFOLIO PERFORMANCE

Performance Summary (%)
Period ending 31.03.2015

Class 1*	B USD	Benchmark **
1 Month	-0.70	-0.21
3 Months	5.09	4.54
2014	16.79	3.26
2013	13.45	3.95
2012	45.90	22.96
2011	-3.96	-15.20
Since Launch+	95.09	17.88
Annualised since Inception	17.03	3.95

* 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: Bloomberg. Total return net income reinvested.

Class 1 B, USD Monthly Performance Summary (%)

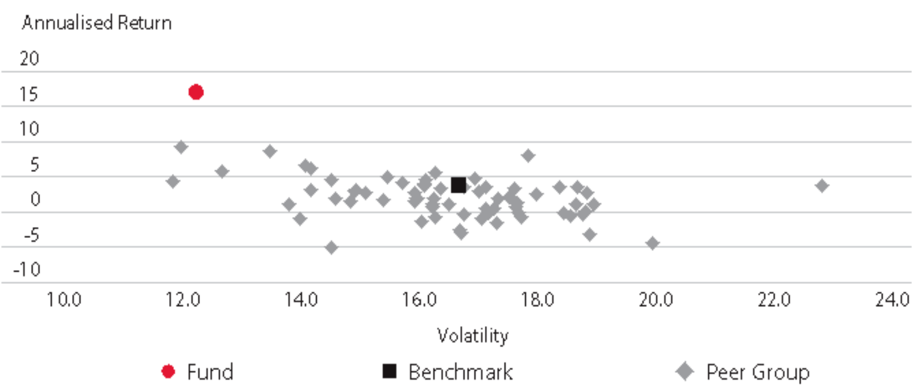
	Jan	Feb	Mar	Apr	May	June	July	Aug	Sept	Oct	Nov	Dec	Total
2015	4.35	1.41	-0.70										
2014	-4.34	4.03	1.50	1.58	4.63	2.14	3.50	1.24	-2.54	2.31	2.00	-0.05	16.79
2013	3.93	1.78	0.35	4.57	-0.53	-4.95	1.87	-2.24	5.07	4.15	-0.56	-0.25	13.45
2012	8.12	6.54	1.92	3.20	-7.67	3.84	6.72	1.92	6.36	1.97	2.76	3.63	45.90

RISK ANALYSIS

Risk Metrics	Fund (%)
Tracking Error (% pa)	6.9
Beta	0.78
Alpha (%)	14.1
Volatility (%)	12.2

Source: Bloomberg
Since inception: B 31.12.2010

Risk Adjusted Performance - Class B USD (%)



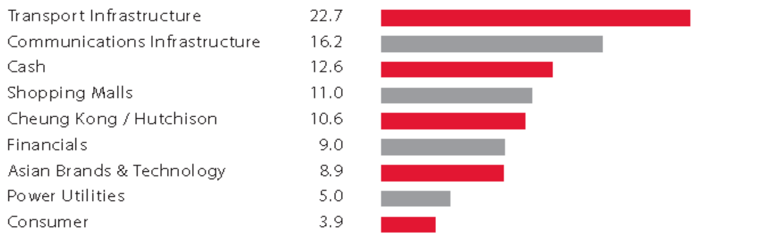
Source: Bloomberg. Annualised return and 1 year volatility versus the peer group (open ended offshore Asia Pacific ex Japan Equity Fund Index), 31.12.10 to 31.03.15

THEMATIC & GEOGRAPHICAL BREAKDOWN

Top 5 Holdings (%)

Hutchison Whampoa Ltd	**6.4**
Samsung Electronics	**5.2**
SK Telecom Co Ltd	**4.2**
CK Hutchison	**4.1**
Macquarie Korea Infrastructure	**3.9**
Total Number of Holdings	**33**

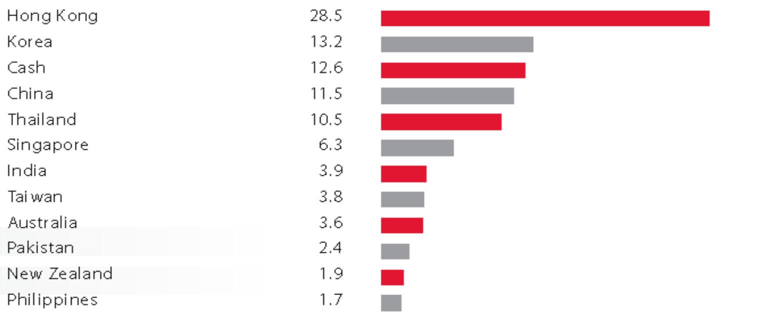
Thematic Breakdown (%)



Portfolio Financial Ratios

Predicted Price/Earnings Ratio	**12.9x**
Predicted Return on Equity (%)	**14.3**
Predicted Dividend Yield (%)	**4.6**

Geographical Breakdown (%)



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

FUND PARTICULARS

Fund Facts

Fund Size USD	**856.8m**
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	200.50
B USD	Unhedged	Distributing	B4QVD94	IE00B4QVD949	164.03
C GBP	Hedged	Distributing	B4Q6DB1	IE00B4Q6DB12	165.39
D SGD	Hedged	Distributing	B4NFJT1	IE00B4NFJT16	157.75

***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	149.07
Y GBP	Hedged	Distributing	B4TRL17	IE00B4TRL175	150.69
Z SGD	Hedged	Distributing	B6WDYZ1	IE00B6WDYZ18	149.13

*** 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	127.15

*** 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)

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