Platinum Asia Investments Limited

Quarterly Investment Manager's Report

31 March 2017

Platinum®
ASIA INVESTMENTS LIMITED

ABN 13 606 647 358

Portfolio Update

by Joseph Lai, Portfolio Manager

Performance

(compound pa, to 31 March 2017)

	QUARTER	6 MTHS	1 YR	SINCE INCEPTION
Platinum Asia Investments Ltd	7%	6%	17%	5%
MSCI AC* Asia ex Japan Index	8%	7%	18%	9%

After fees and expenses. Refer to note 1, back cover.

* Morgan Stanley Capital International All Country

Source: Platinum Investment Management Limited and MSCI Inc.

Net Tangible Assets

The following net tangible asset value per share (NTA) figures are before and after provision for tax on both realised and unrealised income and gains of Platinum Asia Investments Limited (PAI).

	PRE-TAX NTA	POST-TAX NTA
31 December 2016	$0.9860	$0.9860
31 January 2017	$0.9950	$0.9948
28 February 2017	$1.0118	$1.0063
31 March 2017	$1.0554	$1.0367

Source: Platinum Investment Management Limited

The MSCI AC Asia ex Japan Index was up by 10% in local currency over the quarter, however, the strong Australian dollar movement detracted from returns.

Performance was generally encouraging across the region, particularly in India and China. The Indian market, having recovered from the "demonetisation" sell-off as we had expected, was up 12% (in local currency). Demonetisation was essentially an exercise by the Indian government to swap old currencies for new tender. As the bulk of the new currencies are now in circulation, economic activity quickly recovered. We took advantage of the sell-off to add to stocks that were negatively impacted, and they rebounded significantly over the quarter.

The Hang Seng Index (of Chinese companies listed in Hong Kong) rose 10% (in local currency) over the quarter, as the Chinese economy continued to gather pace, benefiting construction and consumption-related stocks.

ASEAN markets also rose higher, as optimism grew in these export-oriented countries on the back of improving economic activity in China and the US, though somewhat offset by the prospect of US interest rate rises.

As expected, the Chinese stocks in PAI's portfolio were contributors to performance, including **BBMG** (a dominant cement producer in norther China) +20%, **58.com** (online classifieds) +26%, **ENN Energy** (natural gas utility) +36%, and **Jiangsu Yanghe Brewery** +24%. Elsewhere, our Indian banking exposure also contributed to performance, with **Yes Bank** up another 27%, bringing its annual return to 69%. Key detractors were our energy exposures (CNOOC).

Changes to the Portfolio

We sold out of positions that have reached our estimation of fair value, such as **Yes Bank**, **HDIL** (Indian real estate developer) and **UPL** (Indian fertilizer company). Funds raised were deployed into more prospective ideas.

We started positions in **Hon Hai Precision Industry** (also known as Foxconn), the largest and the lowest-cost manufacturing contractor for popular electronic products like the iPhone. Hon Hai supplies key components, and its increasingly efficient and sophisticated processing technologies are boosting its negotiation position vis-à-vis its clients. The company's cost position continues to improve with the application of its in-house made robots, which anecdotally have drastically reduced the use of manual labour and improved product quality. These two trends in Hon Hai's operations as well as its prospective growth trajectory appear under-appreciated by the market, with the stock trading on 11x 2017 earnings.

Another new addition to the portfolio was **Midea Group**, one of the top manufacturers of household appliances in China. After years of consolidation, China's home appliance industry is now dominated by only three key players, with one in every three air-conditioners or fridges sold made by one of them. This has allowed these companies to gain pricing power, and product prices have been rising over the last few years while raw material prices fell!

Midea has recently branched out into robotics with the acquisition of a top-tier German robotics company called

Kuka. Kuka is a dominant supplier of car manufacturing robots to the likes of Volkswagen, BMW and Mercedes Benz, while also expanding into general industrial robots for other areas such as the manufacturing of electrical appliances. Midea has invested billions of dollars to upgrade its manufacturing processes with automation and robotics over the last few years. It is worth observing that improving product quality was as important a reason for this investment as cost reduction. The underlying change reflected here is that Chinese consumers are demanding better quality products and the future of the Chinese factory is one that may run 24x7 in the dark, lined by robots! On 12x P/E, with the robotics optionality being largely an added bonus, valuation is tantalising indeed.

The portfolio maintained a 13.5% AUD exposure as of the end of the quarter.

Outlook

China and India are undergoing structural reform to better their longer-term outcomes, and their longer-term prospects remain bright.

In India, with the banking system having been through a clean-up and better institutions (particularly around bankruptcy laws) having been put in, and with progress taking place in the power sector, the country indeed appears to be on the cusp of a long-awaited capex cycle which will accelerate growth nationwide. However, given the enthusiasm with which the market has already embraced the Indian market, improvement in economic activity first has to catch up with the market's optimism.

China is showing very few signs of retreating from its reform agenda. The government continues to force closure of excess production capacity in heavy manufacturing industries, which has led to a significant rebound in commodity prices. While another major fiscal stimulus is unlikely, given the improvement in construction activity and private sector capital expenditure, one can expect a continuation of infrastructure projects which this country of immense population and geographic reach still needs. Against the backdrop of the ongoing rebalancing of China's economy, we have kept PAI's China exposure to the sectors and companies with lower risks and more favourable growth prospects.

Portfolio Disposition

REGION	31 MAR 2017	31 DEC 2016
China (Ex PRC Listed)	34%	26%
China (PRC Listed)	10%	9%
Hong Kong	<1%	<1%
Taiwan	4%	4%
India	14%	16%
Korea	13%	9%
Thailand	6%	7%
Philippines	4%	4%
Singapore	2%	2%
Vietnam	2%	2%
Malaysia	1%	1%
Indonesia	<1%	<1%
Cash	9%	19%

Refer to note 2, back cover.
Source: Platinum Investment Management Limited.

For further details of PAI's invested positions, including country and industry breakdowns as well as currency exposures, updated monthly, please visit www.platinum.com.au/our-funds/platinum-asia-investments-limited/#MonthlyUpdates.

Top 10 Holdings

STOCK	COUNTRY	INDUSTRY	WEIGHT
Kasikornbank PCL	Thailand	Financials	3.1%
Tencent Holdings Ltd	China Ex PRC	IT	3.1%
Ayala Corp	Philippines	Financials	3.1%
Alibaba Group	China Ex PRC	IT	3.1%
Jiangsu Yanghe Brewery	China	Consumer Stap	3.0%
Ping An Insurance Group	China	Financials	3.0%
Axis Bank Ltd	India	Financials	2.6%
Samsung Electronics	Korea	IT	2.4%
Jardine Matheson Holdings	Singapore	Industrials	2.4%
Baidu.com	China Ex PRC	IT	2.3%

As at 31 March 2017. Refer to note 3, back cover.
Source: Platinum Investment Management Limited.

Macro Overview

by Andrew Clifford, CIO

The global economic and political landscape continues to provide a multitude of challenges for investors. President Trump's daily policy pronouncements, the prospect of Marine Le Pen winning the French presidential election in May and, with that, the possibility of France looking to exit the European Union (EU), and China's ever-growing mountain of debt, are just some of the issues that investors need to consider. To add to that, US interest rates are on the rise and valuations of US stocks are at extremely high levels. We could go on and on. Yet, in the face of all these concerns, global stock markets have continued to move steadily higher!

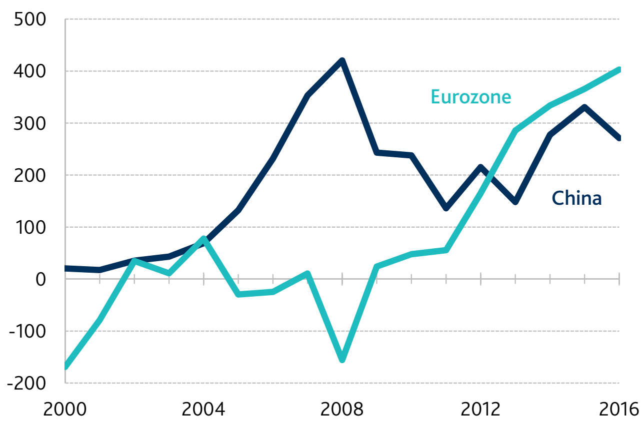
At Platinum, it is our view that the very risks that investors become fixated on are often the source of the greatest opportunities. However, before elaborating on how we see these issues and others playing out for investors, it is worth **reflecting on the key imbalances in the major global economies**, which are not only driving investment outcomes, but also political outcomes.

Income Disparities – The Real Cause of Global Trade Imbalances

Most readers would be well aware of the massive trade and current account surpluses that China has produced over the last two decades as it became the unparalleled provider of low cost manufacturing of goods. Less well known is that China is not the only country currently running substantial surpluses. In the period post the Global Financial Crisis (GFC), the Eurozone has turned its current account deficit into a surplus in the order of US$403 billion, and South Korea's surplus has risen fivefold to some US$100 billion. **These provide a useful point of reference for China's surplus of US$271 billion in 2016.**

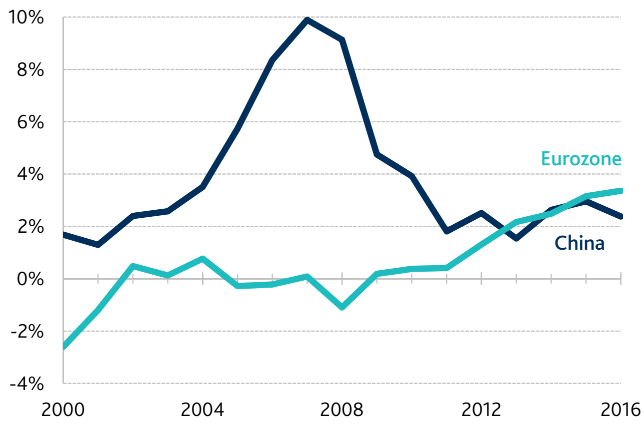
China's substantial surplus is often attributed to the country's advantages in terms of low labour cost as well as other variables such as cheap industrial land, weak environmental regulation, generous government subsidies, and an undervalued exchange rate. While all of these elements have certainly played a role in making Chinese exports competitive, the fact that the Eurozone and South Korea have substantial surpluses without the benefit of such advantages suggests that there is more to this story of trade imbalance. **At the core of the problem in the surplus economies is the distribution of income.** In China, the household share of GDP is unusually low, with household consumption expenditure accounting for only 38% of the economy. The other side of this equation is that businesses and government (more via state-owned enterprises than tax revenues) account for an unusually large share of GDP. This has served China well, as the corporate sector (whether privately-owned or state-owned) was behind the extraordinary investment boom that has driven China's growth to date. But herein lies the problem! **As the corporate sector exhausts its investment opportunities,** with some capital-heavy industries like steel now facing contracting capacity, **it will find its cash flows increasingly exceed its capital expenditure needs.**

China and Eurozone Current Accounts (USD, billion)



Source: IMF, Platinum Investment Management Limited.

China and Eurozone Current Accounts (as a % of GDP)



Source: IMF, Platinum Investment Management Limited.

These savings of the corporate sector are the source of China's trade surplus, as they remain in the hands of those who have no way of spending them. Imagine for a moment if these excess funds were instead in the hands of Chinese households rather than a narrow group of private and public shareholders. They would likely be spent on housing, autos, and a range of consumer goods from handbags and shoes to holidays. Moreover, while a good proportion of these goods and services would be domestically produced, there would also be a significant element of imports, such as aircraft, semiconductors, overseas travel and the like, which would drive down the trade and current account surplus. **Such a consumer boom would itself engender significant investment in a range of industries, not only in China, but globally.** It is for this reason that we focus intently on the Chinese consumer – this sector of the economy must prosper if China is to continue its rapid development and transformation.

The income inequality between China's corporate sector and households is also present in the developed world, but there the inequality is more evident in the distribution of income across households. Between 1994 and 2014, the real income of the top 20% of households in the US grew by 16% while the bottom 20% experienced a 4% decline. The growth in income for the majority of US households initially resulted in a consumer boom which was reinforced by the draw-down in home equity via mortgage refinancing until 2008. However, this boom in consumption, together with the resulting debt burden, left the American consumer with little appetite for further spending. Indeed, since 2008, as income further accrued to middle income and wealthy households, debt repayments and savings have become the focus. As is in China, **income is accruing in the hands of those less likely to spend**. If this trend in income disparity were reversed, lower income households would likely display a much higher propensity to spend, not only boosting total consumption, but potentially creating new investment opportunities as well. The rise in income inequality experienced by the US can be observed across most of the developed countries, though the redistribution mechanisms of taxation and government spending have generally been more effective elsewhere, leading to less extreme outcomes.

Interestingly, though, **while income inequality has resulted in substantial trade surpluses for China and, for that matter, Germany and South Korea, the United States saw the opposite outcome**. To examine this issue we need to consider two important relationships that exist in all economic systems. The first is that a current account surplus will always be exactly offset by a capital account deficit. When China, Germany and South Korea run current account surpluses, they are exporting their excess savings via the capital account to economies that run current account deficits, such as the US, the UK and Australia. The other key relationship to consider is that in a closed economy, all savings will be invested. Savings by definition always equal investment. Thus, in the global economy, which is most certainly a closed system, the excess savings of the surplus countries will be invested elsewhere.

The **export of excess savings by the surplus countries** has been a key to many of the boom-and-bust scenarios seen around the globe. In the years leading up to 2008, these excess savings found their way into the US housing market, in the first instance driving up investment in housing. The secondary effect, though, was to allow households to draw down on their home equity to consume more of their income, thus balancing the investment and savings equation globally by reducing savings in the US. The next destination for the surplus countries' excess savings was investment in the resources sector, notably here in Australia and in unconventional energy resources in the US and beyond. In recent times we have seen these funds finding their way into residential apartments in Australian capital cities and other major cities around the world. The most notable destination, however, has been financial assets. US bonds, shares and property, seemingly attractive as a relatively "low" risk destination, have been key beneficiaries of these excess savings looking for a home.

It is in this context that one might see that **the trade surpluses President Trump rails against are a function of more than just export competitiveness and protectionism**. Excess savings in places like China enabled US households to increase their spending (via home equity draw-downs), thus creating the relative trade positions of the two countries. Had the Chinese been big spenders and their current account turned to deficit, there might perhaps have been a reversal of roles.

A Possible Rebalancing May Be Under Way

The Health of the Chinese Consumer

Equipped with this understanding of the interplay between global trade imbalances and income disparities, we can now examine some of the forces that have been influencing markets and causing investors concern.

The one place where there is good news, and thus great opportunities for investors, is China. As explained above, one of the main causes for China's excess savings has been the income disparity between households and the rest of the economy. Ideally, one would hope to see household income growing faster than the economy as a whole and government policy generally favouring such an outcome.

It is not always easy to observe such changes from China's government statistics, but there are numerous signs showing that the Chinese consumer is doing well. Foremost amongst these is the ongoing strength of residential property sales. While the volume of property sales has fluctuated over recent years, the downturns have primarily been in response to government initiatives to curb speculation. When restrictions are removed, sale volumes have typically rebounded strongly. 2016 saw sales of approximately 16 million apartments, compared with the previous peak of 13 million in 2013. While these volumes are enough to cause consternation amongst foreigners, the cumulative volume of apartments sold since 1999, when private ownership of residential property was first legalised, is in the order of 130 million. Essentially, this represents the entire modern housing stock of the country. For the 400 odd million households remaining in communist era housing, it remains a question of affordability. Nevertheless, considerable latent demand for new housing exists. It is also worth noting that mortgage debt, while now growing quickly, is only at about 36% of China's GDP, and that buyer surveys have continually estimated that owner-occupiers account for 85% to 90% of all apartments sold.

The auto market is another health indicator for the Chinese consumer. Throughout China's economic slowdown over the past few years, the passenger vehicle market has continued to grow. Vehicle sales have grown steadily from 15.5 million in 2012 to 24.4 million. As auto finance is not broadly available, 80% to 90% of these purchases are paid for with cash. There is ample evidence that the Chinese consumer is in good health, which is all the more impressive given that millions of jobs have been lost in the construction and related sectors in recent years. Government policy is generally supportive of higher household incomes. In particular, we would note rural reforms and wage hikes for government workers as examples. The bigger driver, however, is likely to be the relatively fully employed workforce that continues to experience healthy income growth.

China's Debt Problem

Few observers would likely challenge our view that the Chinese consumer is in good shape. The issue that concerns most is the ongoing growth of China's debt level, with the broadest measures growing by 14% in 2016, reaching 256% of GDP. An examination of the available data indicates that the growth in the use of credit is predominantly attributable to state-owned enterprises (SOEs), which raises the question of whether these funds are being applied productively. Some Chinese banks indicated at our recent meetings that the principal target for their lending to the SOEs is government sponsored infrastructure and related projects. However, fears remain that this credit is being used to prop up loss-making ventures in order to maintain employment. We think the truth is likely to be a combination of both. **To the extent that loss-making ventures are being supported, this ultimately is a form of fiscal spending by the government and one should treat any such loans as part of the budget deficit.** It is worth noting that last year's supply side reform in the coal and steel industries saw capacity closure, loss of jobs, and significant improvements in profitability – a signal that the government no longer readily accepts the status quo of loss-making SOEs. We would also add that many SOEs are profitable and, as such, are an asset on the government's balance sheet. Ultimately, without greater transparency, there can be no clear conclusion to this discussion. However, we would note that the overall position of government finances in China is extraordinarily strong, and the current debt level is likely to be sustainable for some time.

What all of this means for China is an economy where the consumer sector becomes more prosperous, an aggressive infrastructure building program provides another source of growth in activity, while heavy industry, dominated by SOE ownership, continues to muddle through. In this case, China will ultimately outgrow the problems caused by its investment boom, much as the US has done post its 2008 collapse. Of course, the banking system will continue to experience nonperforming loans, but these are an accounting entry for losses that have already been incurred. However, this pattern of development will likely see China's trade and current account surpluses decline, a process that has already begun in 2016 when the surplus fell by almost 20%.

Proposed Policy Changes in the US

A declining surplus, as per our earlier discussion, will see China's export of excess savings decline. Before we ponder the implications of this trend, however, it is worth considering the policy changes that have been proposed in the US. It is quite possible that some of the changes proposed will be "positive" for the stock market in the short-term, though are ineffective economic policy. Take, for example, the simple case of a corporate tax rate cut. There is no question that a lower tax rate will initially increase the earnings of companies, all else being equal, thus making them more attractive to investors. The real question is whether these additional funds will encourage US companies to invest more in the US. To some extent one imagines they will, but US company profitability has never been higher than it is today, yet, investment remains subdued. If the current pattern of corporate behaviour were any guide, companies will likely pass additional earnings onto shareholders through dividends and share buy-backs. **Such a result will reinforce the income inequality by funnelling more income to the**

highest income groups in the economy who have a low propensity to consume. Similarly, the failed repeal of Obamacare, had it succeeded, would have taken benefits away from the lowest income households, a group with a high propensity to consume.

A variety of measures have been floated to reduce the US trade deficit, from a border adjustable tax system to straight tariffs on imports. Some high level observations can be made. Firstly, if at the core of the global trade imbalances are, as we have suggested, the excess savings in China, Europe and South Korea that are a result of income distribution in these countries, the solution is unlikely to be found in trying to reduce imports. Indeed, when one looks at the extraordinary ecosystem of product design, prototyping, manufacturing, packaging, shipping and logistics found in China's Pearl River Delta, one quickly realises the impracticality of the idea of moving manufacturing back to the US in any meaningful way. According to one contact in one of our recent meetings, manufacturers in the apparel industry who have moved production to Vietnam or Bangladesh still ship their products to China in order to take advantage of the existing supply chain before shipping to Europe or the US. It will be harder than simply finding 25,000 workers in one location to take on the work. This is not to say that tariffs will not reduce the trade deficit, but that it will do so by reducing income (and thus savings) in the exporting countries. The US consumer will face higher prices for a wide range of imported goods, and inward capital flows will decline.

The one policy that the US administration has proposed that has the greatest potential to improve the country's outlook is increased investment in public infrastructure. As we have stated, America's trade deficit has resulted in offsetting capital inflows, but the problem has been finding a productive investment for these funds. Investment in public infrastructure is one possibility. However, a practical challenge is the lack of consensus among the various factions within the Republican Party on these issues and the questionable competence of the new administration. It should be remembered that changing any system, no matter how well thought-out and well-meaning, will always involve a loss to entrenched interests who will fight the changes to the bitter end.

Political Risk in Europe versus Economic Recovery

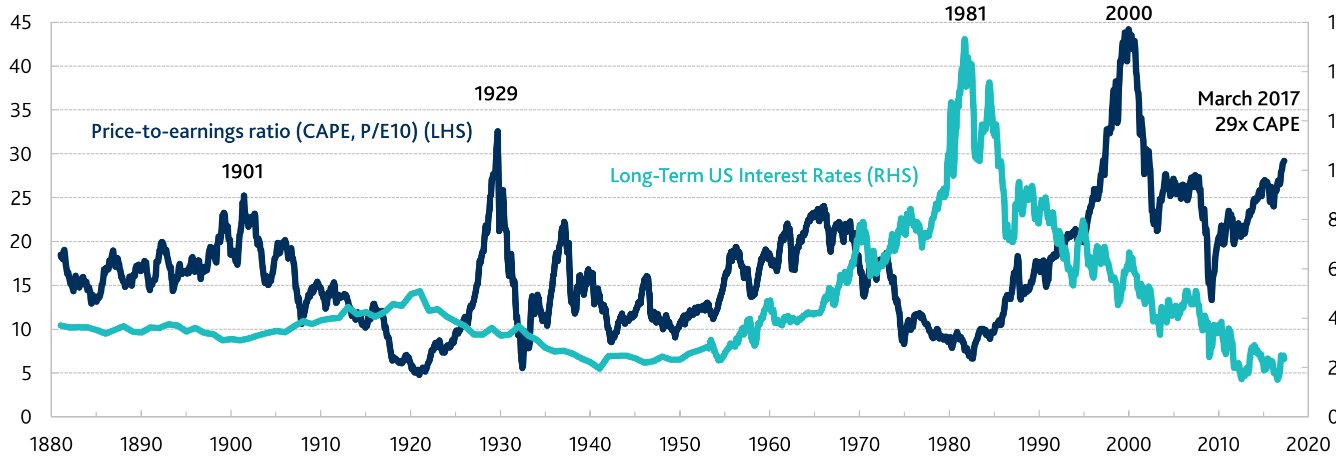
In France, the consensus among political commentators is that, while Marine Le Pen will make the final run-off for the presidential election, she is unlikely to win the election. After Brexit and the election of Trump in the US, the confidence of markets in such political forecasts is understandably low. A Le Pen victory will, at a minimum, create significant uncertainty about France's ongoing position in the EU and the Eurozone. Even if Le Pen does not win, the cloud of uncertainty will not entirely go away as all will be examining the ramifications of the German elections in September and the Italian elections in 2018. With investors focusing on the political risk in Europe, what is not being widely discussed is how the EU's economic recovery is steadily making progress. Between 2008 and 2012, the Eurozone countries lost five million jobs. Since 2012, employment has grown strongly with almost 10 million jobs created with another million added in 2016. Meanwhile, across Europe auto sales and property prices are approaching their pre-2008 levels, and there are signs that demand for credit is starting to rise. There is a possibility that better economic conditions in Europe will begin to reduce the anti-EU/anti-Euro sentiment that is present in parts of Europe. One might also reasonably expect that stronger economic conditions will see stronger personal consumption, leading to stronger imports and peaking in the region's current account surpluses.

Markets

The key risk for markets that we are yet to address is rising US interest rates. The US Federal Reserve has slowly started the process of lifting interest rates, with the discount rate increased three times over the last 15 months and now standing at 0.75%. However, it should be remembered that we had been through a period of unconventional monetary policy with quantitative easing (QE). Economists who have modelled the impact of QE suggest that it was worth 2% to 3% of rate cuts. In other words, the effective discount rate was -2% to -3%, and thus, with the removal of QE, the US economy has experienced rate increases equivalent to 2.75% to 3.75%. While this modelling may not be entirely reliable, the point is that we are probably further into a monetary policy tightening cycle than the headline figures suggest. While the US economy and stock market tend to be immune to initial increases in interest rates, ultimately, it will reduce growth and profits, and with that the market falls. **There is probably no more reliable correlation between the stock market and economic variables than the one it has with interest rates.**

In the meantime the US economy continues to show improving strength with the labour market, on some reckonings, as strong as it has been since the 1970s. Of note is that over the last three years the lowest income households have been seeing their income grow faster than the average. Add to this the boost to consumer and small business confidence from Trump's election win and you have conditions that should continue to underpin economic growth. Of course, ongoing good economic conditions may well encourage the Fed to keep increasing interest rates. This

Cyclically-Adjusted P/E of the S&P 500 Index and US Long-Term Interest Rates



Source: www.econ.yale.edu/~shiller/data.htm

is a dangerous situation when combined with the fact that the US market is trading on a valuation that is high by historical standards. Indeed, the cyclically adjusted price-to-earnings ratio[1] of the S&P 500 Index has only been at this level or higher in 1929 and 2000, on the eves of the Black Tuesday crash and the Dot Com Bubble burst respectively. While predicting the timing of any sell-off is problematic, the risk of a large sell-off is rising. What could detract this in the short-term is a significant cut to the corporate tax rate. Across our portfolios, we have maintained a relatively low exposure to US stocks, particularly relative to benchmarks and the majority of other managers.

The French election clearly represents a risk to markets, but these types of risk are not easily managed. Usually ahead of such events investors position themselves in a way that results in unanticipated market moves even when the undesirable outcome transpires. With Brexit, while the stock market sold off briefly after the event, it has rebounded significantly and is almost 15% higher today than it was on the day prior to the vote. However, the British pound did take a battering and remains almost 20% lower. With the US election, many investors had expected a significant sell-off in the event of a Trump win and were caught out badly as the market rallied strongly when the event happened. Directly playing these types of outcomes is a difficult game and such speculative strategy is not part of Platinum's approach. We would simply note that our French holdings are multinational consumer product or drug companies whose fortunes are relatively immune to local conditions. In addition, holding cash in the portfolio allows us to take advantage of any sell-off that may occur.

1 The cyclically adjusted price-to-earnings ratio (or CAPE ratio) is current price divided by average earnings per share over the last 10 years, adjusted for inflation.

Outlook

In the years since the GFC, investors globally have craved certainty, and this has driven a preference for perceived low risk assets such as bonds and, in the equity markets, stable earning assets such as consumer goods, real estate and utilities (often referred to as "bond proxies"). Conversely, investors have sought to avoid the uncertainty associated with companies, industries and countries facing any challenges or cyclicality. We think this is precisely where the opportunity for investors lies. The valuations of stocks in China, South Korea, Japan and, to a lesser extent, Europe, remain at attractive levels. Of course, these regions have the very elements of uncertainty and cyclicality that investors have wished to avoid. We are of the view that improving economic conditions in these major economies outside of the US presage a greater willingness by investors to take on this perceived risk, thereby taking advantage of the better returns on offer in these markets. This process has already begun in the second half of 2016 with improving performance in emerging markets, cyclical and financial stocks, and rising yields on bonds.

In the longer term **we could potentially be entering a period where a significant rebalancing of global current and capital accounts substantially changes the dynamics of global capital flows**. In China, this will in part be a natural consequence of the consumer economy taking hold, but likely also requires reform that redistributes income towards the household and away from the state. In Europe and elsewhere, the surpluses may recede as cyclical recovery strengthens and the pressure builds for fiscal spending to redistribute income within these economies. Such a rebalancing would be a healthy outcome in aggregate for the global markets and economies; however, the removal of capital flows from areas that have unduly attracted capital may result in some dramatic adjustments.

Observations from a Recent Trip to China

by Andrew Clifford, CIO

In late March I visited China, meeting people from a wide range of different businesses and backgrounds. Many of the meetings were with representatives of unlisted businesses, which ranged from distributors of consumer products, commodity traders, Internet-based finance companies, to small state-owned coal miners and regional banks. This type of schedule differs from our usual meetings with management of listed companies, but over the years we have found that these trips provide a very different perspective on China from our traditional schedule and, as such, can offer valuable insights on what is always a rapidly changing landscape.

The Rise of Local Brands

One meeting was with the distributor of fast-moving consumer products (shampoos, soap powder, etc.) that represented a very large and successful multinational company in a region within Guangdong province. He highlighted that one of the challenges for the business was the rise of new local brands. In the past, these start-ups had been kept out of the market because of the sheer cost of large scale advertising on TV and in print. The advent of digital advertising has opened a door for these companies and, what is more, it enables them to target very specific groups, such as 15 to 25 year old women. Interestingly, many of these new brands are having success with products priced at a premium to foreign brands. Together with digital marketing, e-commerce is a distribution channel that has also reduced the barriers for smaller local companies. A meeting with a company that manages the online presence for some of the smaller multinationals in China highlighted that selling online is much more than just setting up an e-store on T-Mall (the Alibaba e-commerce platform) and sitting back and waiting for sales. There is an ongoing daily need to adjust the offering, put on promotions, bid for keywords and the like. According to the distributor we spoke to, this poses another challenge for his multinational principal who, while well aware of the need to respond to these challenges, simply cannot move fast enough.

The rise of local brands highlighted in these discussions comes as a direct contradiction to the often-heard mantra in the financial markets that the multinationals have a sustainable advantage in China due to concerns around product safety. An amusing story, though, is that of one successful local company which had given itself a name and brand to create the impression as if it were a Korean company. This worked well until China's recent fall-out with Korea for facilitating the US anti-missile defence installation which led the Chinese government to direct its patriotic citizens to avoid all things Korean!

The other observation on local brands came from the auto market. An industry expert (an American who has had a long involvement in the Chinese market) reported that the difference in quality between good local Chinese carmakers and foreign brands is by and large imperceptible to the Chinese buyer. This may well be somewhat of an exaggeration, but the independent JD Power survey on product quality actually supports the claim with respondents citing only a minor difference between local and foreign makes in terms of product quality. Of course, more important than perceptions are sales, and numbers have spoken louder than words with the domestic producers' market share having risen from 30% in 2012 to over 40% in 2016. In this period, China's passenger vehicle market increased by approximately 10 million vehicles annually, of which 5.7 million were supplied by domestic brands in 2016.

The Ubiquity of Alipay

Alipay is an electronic wallet or online payment system that grew out of Alibaba's e-commerce platform in much the same way that PayPal had developed hand in hand with eBay. In China, however, Alipay has evolved to be much more than a way of settling online payments and, in the absence of a deep network of credit card and EFTPOS terminals, has become the way of settling essentially any transaction. Payments can be made from the app on one's mobile phone directly to the recipient. Setting up an account is straightforward and funds are transferred into and out of one's Alipay account via one's Chinese bank account. The best news for merchants is that no fees are charged, making the system very attractive. What we were continually told by the locals is that there is simply no longer a need to carry cash, ATM cards or credit cards, as everyone from the street vendor of snacks to taxis and organised retailers accepts Alipay. This claim I suspect is somewhat exaggerated and was difficult to test, as, without a Chinese bank account, I couldn't complete my own registration. Alipay claims to have 450 million active users and settles 200 million transactions daily. Annual transaction value is estimated at US$3 trillion. Needless to say, Alipay has many competitors, most notably, Tenpay, which is Tencent's e-payment platform and is integrated with the hugely popular WeChat app. It is once again an interesting example of how China has bypassed the developed world's approach and may well be moving to a cashless system faster than the West.

While the transfer of funds within Alipay attracts no fee, the platform hosts a universe of services by third parties from which Alipay does make money. One company we met is in the business of providing small (RMB 1000, or A$200) short-term (30 days) loans to university students. The company is having great success and incurring only a trivial level of nonperforming loans. The key lending criteria are based on the credit rating data provided by Alipay, which of course has quite a rich pool of data on the applicant's payment history. This is notable because a group of consumers are gaining access to credit they never had. Similar businesses operate in the field of small business loans. In these transactions Alipay makes money only from the sale of the credit rating data. Other products on the Alipay platform include managed funds and insurance.

If the Alipay model were replicated in developed markets, the implications for credit card issuers and merchant acquirers as well as others who make a living off the payment system could be quite dramatic. Of course, this may be easier said than done, but undoubtedly many will be trying to emulate Alipay's success. Ant Financial, the company that owns Alipay, is currently privately owned. But the listed Alibaba Group has a right to purchase 33% of Ant Financial's shares when it becomes listed. Alibaba is a top ten holding in PAI's portfolio.

The Pearl River Delta

In Taiyuan, the capital of Shanxi province, we met with managers of the local Foxconn plant. Foxconn is part of the Hon Hai group, the world's largest contract manufacturer for electronics and best known for manufacturing iPhones for Apple. This Foxconn plant is a producer of components for the Hon Hai group. Taiyuan is coal mining territory and some 500 km from the coast, not quite the typical location for this type of endeavour. The Taiyuan operation, however, has an impressive 75,000 person workforce, up from 50,000 a year earlier. When one thinks of the challenges of hiring and training 25,000 workers in a year, the idea of moving this type of operation to the US becomes difficult to imagine.

Another meeting in Guangzhou later in the week with an expert in the design and manufacture of IT products made it even more apparent that President Trump's plans of moving this type of activity back to the US, to any significant degree, has little chance of success. In the Pearl River Delta at the south-eastern end of China, there is an entire ecosystem of service providers, from design, manufacturing and packaging to logistics and transportation, that deliver goods to the rest of the world at extraordinarily low cost. For the individual with a product idea simply sketched out on a piece of paper, there are service providers who will turn the sketch into CAD drawings and create working prototypes using 3D printers, all at a trivial cost. Or, more questionably, if you would just like to copy someone else's products, there are providers who will reverse-engineer the product right down to the semiconductor and printed circuit board level. Of course, custom packaging can readily be created for your "new" product. All of this can be done in a matter of weeks, and from your desk anywhere in the world. Once you are ready to produce, there are traders who can provide standard components, and who, because of the extraordinary volumes they handle, will supply to you well below list prices. And then, of course, there are plenty of contract manufacturers.

Then comes the logistics side of the equation. If, for example, you wanted to sell your new widget on eBay, you can have the whole fulfilment and shipping run out of China. Assuming you earn at least US$0.75 on your product, you would, we were told, in most cases be able to afford to offer your customers free shipping to anywhere in the US! The one downside to this is that the delivery time is measured in weeks. The most telling story is that many apparel and footwear manufacturers who have moved production to places such as Vietnam and Bangladesh are shipping their products to Shenzhen prior to shipping to the US or Europe, in order to hook into the logistics and fulfilment supply chain of the Pearl River Delta.

Supply Side Reform

An important development in China during 2016 was the supply side reform in the steel and coal industries. A directive from the State Council early in the year called for sub-scale plants and mines and those not meeting environmental or safety standards to be closed. The policy was directed at the state-owned enterprises (SOEs). Historically, such directives from the centre have often had little impact, but this time, and perhaps as a result of President Xi's consolidation of power within the Communist Party, the directive was followed. It is estimated that 85 million tonnes of steel capacity and 290 million tonnes of coal capacity have been closed down, though, admittedly, some of these closures were of capacity that was not operational. Production limits were also placed on remaining coal mines which were restricted to 272 days of production annually. The response to these measures was a more than 100% rise in coal prices in less than six months and a return to profitability for the steel and coal industries. This is all well known.

The interesting insights came from meeting with people who were familiar with some of the coal mine closures that took place in Shanxi. They described the closure of two small mines in the province owned by a local SOE, which not only had low output, but also very short mine lives. These were mines that had in recent years been loss-making. Asked why they had not been closed earlier, the response was simply that the local SOE had responsibilities to maintain employment in the province, though a fund established by the central government to compensate redundant workers had allowed them to pay laid-off workers sums equal to two years' wages. Asked about any outstanding debt to banks on these operations, we were informed that the burden of these debts was now being borne by the SOEs in other operations, which are now very profitable.

The other interesting observation is how the local provincial government and banks view the issue of overcapacity in industries. As the coal industry has now returned to profitability in Shanxi, the local government has seen a significant rebound in taxation revenues, and presumably also benefits from being the owner of profitable entities. The coal mine closures and the production restrictions have created shortages in the coal market, and the production restrictions have been removed. However, in Shanxi, the provincial government is considering making the limit on production days a permanent measure, having seen the benefits of a profitable industry.

Similar benefits have been felt in the banking system. The coal and steel industries collectively account for around RMB 7 trillion in debt, and the unofficial view was that nonperforming loans were running as high as 40% of the total loans. Today, post the supply side reform, the vast majority of these loans would be performing. This makes the cost of redundancies of RMB 100 billion look very attractive for the government who otherwise would have ultimately been on the hook for these nonperforming loans. Many are sceptical about the sustainability of this supply side discipline in China, and, undoubtedly, some closed capacity has been re-opened, given the more favourable market conditions. However, we also heard from banks that were refusing to provide working capital loans to steel and coal companies that needed funding to restart operations.

One foreign businessperson that we met on the trip referred to the unholy trinity of local governments, local SOEs and local banks that keeps capacity open where it should be closed, ensuring that the next new area of growth would be overwhelmed by excess capacity. The success of this supply side reform has potentially broken this nexus, though this risks being too strong a conclusion. Certainly, there is discussion of these reforms being applied to other areas where the SOEs are responsible for excess capacity in the market.

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Notes

1. The investment returns are calculated using PAI's pre-tax net tangible asset value (as released to the ASX) and represent the combined income and capital return of the investments for the specified period. They are after fees and expenses, and assume the reinvestment of dividends. Please note that the results are not calculated from PAI's share price.

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   PAI's portfolio inception date is 16 September 2015.

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2. Regional exposures (i.e. the positions listed other than "cash" and "shorts") represent any and all physical holdings, long derivatives (stock and index), and fixed income securities as a percentage of PAI's net tangible asset value.

3. The table shows PAI's top ten long stock positions as a percentage of PAI's net tangible asset value. Long derivative exposures are included. However, short derivative exposures, if any, are not.

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