Platinum Asia Investments Limited

Quarterly Investment Manager's Report

30 September 2016

Platinum®
ASIA INVESTMENTS LIMITED
ABN 13 606 647 358

Performance

(compound pa, to 30 September 2016)

	QUARTER	6 MTHS	1 YR	SINCE INCEPTION
Platinum Asia Investments Ltd	6%	10%	2%	1%
MSCI AC* Asia ex Japan Index	7%	11%	7%	7%

* Morgan Stanley Capital International All Country

Source: Platinum and MSCI. Refer to note 1.

Platinum Asia Investments Limited (ASX: PAI) returned 6.3% for the quarter. Performance was led by Chinese stocks listed outside mainland China, with Hong Kong listed H-shares up 10%, while the mainland A-shares were less buoyant, up about 3%. Improving economic data suggests that the country's multi-year economic slow-down is beginning to bottom out, drastically reducing the risk of any imminent financial system collapse. India continued its strength from the previous quarter, up 4% on significant economic reforms and a fall in inflation, leading to interest rate cuts. The one-day sell-off at quarter-end over a minor skirmish with Pakistan detracted from returns temporarily, which have since more than recovered. ASEAN markets were mixed due to domestic political factors, despite a further delay in US interest rate hikes.

Our Chinese holdings were strong performers, including Sina (majority owner of Weibo, China's equivalent of Twitter and Instagram combined, up 51%), Anta Sports (a leading domestic sportswear brand, up 36%), Alibaba (the dominant e-commerce marketplace, up 33%), and Tencent (the Facebook of China, up 21%). Our Korean holdings also performed well, with SK Hynix (memory chip producer) up 24% and Samsung Electronics up 12%. In India, our private sector banking and gas positions did well, with IDFC Bank up 77%, Yes Bank up 13% and Indraprastha Gas up 24%. The drag on relative performance came from our Philippines holdings, with Ayala Land and Vista Land both remaining flat for the quarter.

Net Asset Value

The following PAI net asset value per share (NAV) figures are respectively before and after provision for tax on both realised and unrealised income and gains.

	PRE-TAX NAV	POST-TAX NAV
30 June 2016	$0.9338	$0.9338
31 July 2016	$0.9612	$0.9612
31 August 2016	$1.0136	$1.0087
30 September 2016	$0.9928	$0.9928

Source: Platinum.

Disposition of Portfolio Assets

REGION	SEP 2016	JUN 2016
China (Listed Ex PRC)	29%	24%
China (Listed PRC)	9%	7%
Hong Kong	3%	3%
Taiwan	2%	4%
India	18%	21%
Korea	9%	10%
Thailand	7%	7%
Philippines	5%	5%
Vietnam	2%	2%
Malaysia	1%	0%
Singapore	0%	3%
Cash	15%	14%

Source: Platinum. Refer to note 2.

Changes to the Portfolio

PAI's total invested level as at the end of this quarter remained substantially the same as at June end. Economic prospects for the region remain bright, but certain regional markets have done particularly well, possibly reflecting too much enthusiasm too soon.

We raised some cash from the sale of stocks that have reached our assessment of fair value (CK Hutchison, Advanced Semiconductor Engineering and Indraprastha Gas), and deployed some of the cash raised into new positions exposed to the interesting and burgeoning themes in the region.

Yutong Bus is a dominant bus manufacturer in China with excellent management and an impeccable track record. It is also gaining significant experience in the rapidly growing category of electrically powered buses. The company is well positioned to become a global leader in electric buses as China ramps up its efforts to broaden its electric vehicle ecosystem.

BBMG is a leading Chinese cement company with a 70% market share in the region comprising Beijing, Tianjin and Hebei. This economic cluster is being developed into a vast world-class manufacturing and business hub of northern China, covering about 217,000 km^2, more than 100 million people and an economic output in excess of US$1 trillion! Cement prices had been depressed over the last few years, but improving demand has already lifted prices by more than 20% so far this year, and profitability is expected to improve significantly. Trading at a substantial discount to its net asset value makes this investment tantalisingly attractive.

Other additions to the portfolio include **Genting Berhad** and **Wynn Macau**, which own unique gaming properties in various Asian regions. The declining gaming volumes over the past few years provided us with an opportunity to acquire these positions. What attracted us to these companies is that we are on the cusp of a sustainable recovery, supported by the continued growth of Chinese outbound tourism and the development of Macau into a diverse entertainment hub.

Commentary

China

The recent quarter saw further evidence of broad-based economic stabilisation in China, with the obvious beneficiaries being the commodity complex. Investors in commodity stocks would have noticed that thermal coal prices moved up from around US$50/ton earlier in the year to more than US$70/ton. Coking coal, which is used for manufacturing steel, saw even more dramatic rises, with prices more than doubling from three months ago.

Coal mine closures in China provided support for prices. China's coal industry has a closure target of 6% for 2016, more than half of which has already been achieved, surpassing last year's full year closure.

Apart from benefiting from supply closures, prices are further supported by a pick-up in industrial activity. In recent months, we have seen unequivocal signs of improvement. Electricity generation rose 8% for the month of August, having stagnated for most of the year. Growth in rail freight volume also turned positive in the same month, indicating greater economic activity. Excavator sales were up 50% this quarter, after many years of doldrums. Heavy truck sales were up strongly. Car sales are powering ahead, having grown 15% year-on-year in the first eight months of this year. Air conditioner sales, which had slumped with much unsold inventory in the last two years, are also picking up. Our positions in Weichai Power (heavy truck maker), Qingdao Haier (white goods manufacturer) and China Resources Gas (downstream gas distributor) are set to benefit from these trends.

Improving construction activity has come about as a result of deficit (3% of GDP) spending and a recovery of the property market. In our previous quarterly reports we have discussed at length the underlying health and durability of a large portion of the Chinese property market. Our view is that the health and outlook of China's property market are region-dependent. The economically prosperous cities are populated by productive workers who are typically big savers. With mortgage lending still meaningfully under-represented in the banking system (some 21%, compared to 63% in Australia), financing for the purchase of properties can continue for some time.

The number of unsold apartments, as measured by sellable gross floor area relative to average monthly sales, has fallen to nine months for the 35 leading Chinese cities, the lowest level since 2011. Housing starts turned positive year-on-year in the first half of this year after two years of contraction.

Lack of demand is clearly not a problem. The current official mortgage rate of 4.9% can be further reduced, if needed. In cities with a robust economy, demand has in fact proven excessive, leading to the reinstatement of buying restrictions which typically result in a reduction in transaction volume. Curbs on speculative demand will stay, but a drastic mortgage tightening at this point is unlikely.

While one may be tempted to extrapolate the condition of the property market to a boom in commodities, we would caution against it. The base is big. Property construction may well stabilise, but is unlikely to grow significantly. Fiscal stimulus can be expanded, but the constraint is inflation further afield.

A steady expansion is perhaps the preferred solution, biding time for the authorities to tackle the difficult structural problems facing the Chinese economy, such as carving the bad debts out of the banking system and transitioning the economy from construction-linked industries with excess supply (e.g. steel mills, cement plants) to one that is more dominated by consumer and service related sectors.

The crux of China's bad debt problem relates to the structure of its economic system in which state-owned banks have generously funded state-owned enterprises (SOEs). While the most vibrant parts of the economy are driven by private enterprise (Internet, retail, IT), the old economy (building materials, mining) still has a preponderance of state ownership. Bank funding fuelled the build-out of excess capacity, so much so that product prices were depressed. Yet, the loss-making "zombie" SOEs were kept alive with more funding, as attempts to close them down were hindered by the fear of causing mass unemployment.

The good news is that **bankruptcies and restructuring of SOEs have started**. This is significant, because in recent years, SOEs are seen as being backed by the state and therefore cannot be allowed to default. Default allows bad debt to be written off from the banking system and for excess capacity to be closed down. Examples of restructuring underway include the bankruptcy of Dongbei Steel, China's largest specialty steel company, after it defaulted on US$6 billion of debt, the restructuring of Sinosteel which has US$10 billion of debt, and the proposed merger of the loss-making Wuhan Iron & Steel with Baosteel, China's largest steel maker.

In the meantime, the banking sector is also undergoing repair. Bad debt is gradually being written off or sold to asset management companies. Some local banks are being bailed out by the bigger regional banks or by private investors.

The thrust of the SOE reform is to encourage these companies to focus more on profitability and less on market share. State-owned companies are starting to report improving profits with better management over profligate spending and investment. This will enhance the health of the banking system.

Undoubtedly, SOE reform, capacity closure and cleaning up the banking system are necessarily painful measures from multiple perspectives. It is no small undertaking and will take time. What is encouraging perhaps is that this is far from the first time that China has had to deal with such problems.

Former Chinese Premier Zhu Rong Ji was faced with almost exactly the same challenges in the late 1990s. The Chinese economy was smaller than it is today, but the magnitude of the problems was greater as China's economic institutions were less robust with SOEs representing a far greater portion of the economy. Zhu dealt with state-owned banks' huge bad debt problems, closed unprofitable SOEs, let go of 40 million workers who had thought of their SOE jobs as "iron rice bowls" for life! Indeed, pundits domestic and abroad attributed China's miraculous decade-long boom since the turn of the century to the bitter medicine taken a few years prior.

Under the bonnet of macroeconomic reform, sweeping reforms are taking place across a swathe of industries (the stock market, the insurance industry, wealth management products, the Internet sector, and healthcare). Generally speaking, the aim is to put in **frameworks to ensure the sustainable growth of these sectors by improving corporate transparency, reducing rent-seeking behaviour and increasing consumer protection**.

The rapidly growing healthcare sector, for instance, has made remarkable improvements in industry practices as a result of regulatory efforts over the last two years. The mentality of drug companies and distributors is changing fast to better fit in with the country's "new normal".

The widespread practice of drug over-subscription is a result of hospitals' reliance on drug sales as a key source of funding (45%) and generous kickbacks by pharmaceutical companies to doctors. This is changing as funding from government subsidies and service fees is being lifted. There is also a pilot program running in 200 cities that removes hospitals' ability to charge a 15% mark-up on drugs, thus reducing the incentive to over-prescribe medication.

China's Food and Drug Administration is cracking down on inefficacious drugs that may not have gone through proper clinical testing. Not only are new drug applications subject to a stricter review process, pharmaceutical companies are also required to re-submit bioequivalence data for drugs already on the market! Some estimates suggest that up to 30% of drugs sold in China have questionable efficacy and these are being phased out.

India

Significant reform measures are gathering pace in India. Inflation is now under control. Coal India is producing more coal than it can sell. Power distributors are being recapitalised and proper incentives are being put in place to curb under-pricing and theft. Gas power plants, which had been unable to secure economically viable gas sources and watched investments worth billions of dollars lie idle, are in operation again. State-owned banks that had been plagued by bad debts linked to failed projects are in the process of repairing their balance sheets. Private sector banks are returning to participate in the funding of new projects. At 128%, the non-financial debt-to-GDP ratio is low and has not changed for more than half a decade. In the next 12 to 18 months, we will potentially see the beginning of a recovery in private capital expenditure, which has fallen by some 70% from its 2011 peak!

The most notable progress over the quarter was the passing of the Goods and Services Tax (GST) legislation by both houses of the Indian Parliament. The GST legislation was thought to be almost impossible to get through Parliament, as it involved extensive negotiations amongst India's fragmented political parties on both federal and state levels. **The longer term benefits of the GST reform should not be underestimated.** It will improve productivity by providing for a nationally uniform tax system for the trading of goods and services and significantly reducing the cumbersome and complicated taxes and duties levied by India's 29 states and seven territories. A widened tax base and simpler compliance processes will also improve tax collection which can be used to fund much-needed infrastructure.

Even though India is benefiting from the low oil price environment and its current account deficit is at a 10 year low, the country is not growing at its full potential. Areas that signalled some improvement early in the year, such as commercial vehicle sales, have now moderated. However, other areas are showing signs of growth: domestic air travel, sales of private vehicles, motorcycles and scooters. India's consumer confidence index is currently the second highest in the world, which is encouraging even though it is probably more telling about the limited growth in other countries.

Another bright spot is road construction, both in terms of project completion as well as allocation of new projects. The National Highways Authority of India (NHAI) has a very ambitious target for new project awards for financial year 2017: 15,000 km. Even if only 70% of the target is achieved, it will be impressive progress. Land compensation has risen significantly, so land acquisition is no longer an obstacle. Also, the government is very supportive of introducing alternatives ways of funding road development. Recently, IRB Infrastructure Developers, one of our holdings in PAI's portfolio, announced its plan to launch India's first infrastructure investment trust to unlock the value from six of its projects.

At the beginning of September, Dr. Urjit Patel, who had been the Deputy Governor of the Reserve Bank of India (RBI) for three years, was appointed RBI Governor. The government demonstrated continuity by appointing someone with great credentials from within the RBI. Dr Patel led the committee overseeing the RBI's monetary policy framework, has a doctorate from Yale University and has served at the International Monetary Fund. The newly appointed six-member monetary policy committee met for the first time at the start of October and voted unanimously for a 0.25% rate cut. Responsible monetary policies have moderated inflation significantly (down to 5%), now allowing headroom for further rate cuts which should be welcomed by the market.

Financials in particular should benefit. IDFC Limited is a non-bank financial company and has had a banking licence granted to its spun-off entity IDFC Bank in 2015. IDFC has a strong two-decade track-record and the upside is significant for new entrants to India's under-penetrated and state-bank-dominated banking market. The last banks to be granted licences were YES Bank and Kotak Mahindra Bank in the mid-2000s, and they grew as much as 1,500% over the following decade.

ASEAN

The past few months saw no shortage of infrastructure spending in ASEAN countries. Unlike their historical pattern of fits and starts, we sense that this time is different. This is significant, as infrastructure consists of productive assets that can dramatically lift income for developing countries. Good quality roads, railways, bridges and tunnels can make a difference between whether goods can be transported from one place to another and therefore whether business enterprises are viable.

In the Philippines, the new President is pushing forward much-delayed infrastructure programs with much more rigour than his predecessors. The government has announced 12 public-private-partnership (PPP) projects in varying stages of preparation, worth close to US$6 billion in total. Nine other infrastructure projects (airports, transport hubs, hospitals) worth more than US$3 billion were approved within President Duterte's first 100 days in office! Elsewhere the country's economic boom has continued, with the latest indicator of economic activity (the Nikkei Manufacturing PMI[1]) printing 57.5 in September, a record high, and economic growth well above 6%.

In Indonesia, the toll road connection between its capital Jakarta and Surabaya, its second largest city, is expected to be completed by 2019. This much-delayed mega project was initiated back in 1988, but most of the development only took place in the last two years after President Jokowi came to power! Since then, the completed distance has doubled to 315 km, nearly half of the planned final length of 757 km. In order to fund more infrastructure projects, the Indonesian government is running a tax amnesty program to encourage wealthy Indonesians to repatriate their hitherto untaxed offshore savings back into the country.

In Thailand, the recent referendum backing a new constitution paves the way for a win by the current government in the 2017 general election. With its power affirmed, the government is in a good position to focus more on realising the country's 12th National Economic and Social Development Plan. The Plan is targeting 5% annualised GDP growth, driven by a 10% annual expansion in public investment and 7.5% in private investment. Early indications are promising. The government put three mass-transit lines up for tender in July and resolved a dispute over operator selection for another extension project. Winning bids are expected to be announced by the end of the year, with construction to start by mid-2017.

Outlook

The outlook is improving across the Asian region, given the progress made on reform and delivery of much needed infrastructure investments. The direction is positive, though there is no way of predicting the exact path that markets will take.

The Chinese authorities are committed to fixing up the system to deliver more steady and balanced growth. It is encouraging that over the last 40 years China has demonstrated time and time again its capacity to deal with bad debt, reform the system, and remove excess capacity in challenged industries to deliver a positive outcome.

India's economy is still small relative to China's, so the bull case for the Indian market is perhaps easier to grasp. We are positive about the country's economic prospects given its ongoing reform and the potential for a cyclical recovery. However, given the market's recent enthusiasm for the country, short-term setbacks are possible if there are disappointments.

We remain optimistic over prospective returns from our companies, as stock prices remain inexpensive in the context of their growth trajectories. We continue to find interesting companies to add to the portfolio.

Joseph Lai
Portfolio Manager

1 The manufacturing PMI (or Purchasing Managers' Index) is an indicator of the economic health of the manufacturing sector, derived from monthly surveys of private sector companies.

Level 8, 7 Macquarie Place
Sydney NSW 2000

GPO Box 2724
Sydney NSW 2001

TELEPHONE
1300 726 700 or 02 9255 7500
0800 700 726 (New Zealand only)

FACSIMILE
02 9254 5555

EMAIL
invest@platinum.com.au

WEBSITE
www.platinumasia.com.au

Platinum® ASIA INVESTMENTS LIMITED

Notes

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

   The investment returns shown are historical and no warranty can be given for future performance. You should be aware that historical performance is not a reliable indicator of future performance. Due to the volatility in the underlying assets of PAI and other risk factors associated with investing, investment returns can be negative (particularly in the short-term).

   The portfolio inception date for PAI is 16 September 2015.

   It should be noted that Platinum does not invest by reference to the weightings of the MSCI All Country Asia ex Japan Net Index (A$) (the "Index") or any other indices or benchmarks. Underlying assets are chosen through Platinum's individual stock selection process and, as a result, holdings will vary considerably to the make-up of the Index. Index information is provided as a reference only.

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.

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