Platinum Asia Investments Limited

Quarterly Investment Manager's Report

31 December 2016

Platinum

ASIA INVESTMENTS LIMITED

ABN 13 606 647 358

Performance

(compound pa, to 31 December 2016)

	QUARTER	6 MTHS	1 YR	SINCE INCEPTION
Platinum Asia Investments Ltd	-1%	6%	2%	1%
MSCI AC* Asia ex Japan Index	-1%	6%	6%	5%

* Morgan Stanley Capital International All Country

Source: Platinum and MSCI. Refer to note 1.

Asian markets were down -4% for the quarter in local currency. With some easing by the depreciation of the Australian dollar, the MSCI AC Asia Ex Japan Index returned -1% in AUD terms.

Most markets in Asia delivered lacklustre performance. The unexpected US election outcome and the prospect of faster US interest rate hikes rattled the Asian markets. In India, the government's bold efforts to curb corruption and counterfeit currency culminated in a dramatic exercise known locally as "demonetisation" which disrupted economic activities in the short-term and led to a sell-off in the stock market.

Markets that are particularly sensitive to US rates were the under-performers, with the Philippines down -11% and Indonesia down -5%. Elsewhere, the Indian market was down -6% and the Hong Kong market returned -9%. The Chinese domestic A-share (+1%), Thailand (+1%) and Korean (+2%) markets were relatively flat.

Within the portfolio of Platinum Asia Investments Limited (ASX code: PAI), the Korean and Chinese A-share companies were the better performers. In Korea, Samsung Electronics and Shinhan Financial were both up +13% while SK Hynix (memory chip maker) rose +11%. In China, Kweichow Moutai (liquor producer) was up +12% while Weichai Power (manufacturer of heavy duty trucks and engines) was up +8%.

Net Tangible Asset

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

	PRE-TAX NTA	POST-TAX NTA
30 September 2016	$0.9928	$0.9928
31 October 2016	$0.9943	$0.9943
30 November 2016	$0.9893	$0.9893
31 December 2016	$0.9860	$0.9860

Source: Platinum.

Disposition of Portfolio Assets

REGION	DEC 2016	SEP 2016
China (Listed Ex PRC)	26%	29%
China (Listed PRC)	9%	9%
Hong Kong^	<1%	3%
Taiwan	4%	2%
India	16%	18%
Korea	9%	9%
Thailand	7%	7%
Philippines	4%	5%
Singapore^	2%	0%
Vietnam	2%	2%
Malaysia	1%	1%
Indonesia	<1%	0%
Cash	19%	15%

^ The changes in the stated Hong Kong and Singapore exposures are largely attributable to the geographic reclassification of Jardine Matheson Holdings (2.4% of PAI's portfolio) from a Hong Kong company to a Singapore company.

Source: Platinum. Refer to note 2.

Changes to the Portfolio

PAI's invested position was 81% as of quarter end, leaving room to further upgrade holdings when opportunities arise. On the currency side, PAI is maintaining its hedge against the depreciating Chinese Renminbi.

During the quarter, we reduced our exposure to stocks that have reached our assessment of fair value while taking advantage of price weaknesses to add to companies with strong market positions and a healthy growth outlook.

PAI initiated a position in **Shriram Transport Finance Company**, the leading finance provider for second hand truck purchases in India. This company has specialised expertise in this niche area and has decades of experience operating in a market where many capable financial institutions have found almost impossible to penetrate. Current valuation has more than factored in the temporary impact of the demonetisation-induced reduction in truck demand, while the company's long-term prospect looks very promising.

PAI also added **Axis Bank**, a strong private bank in India. As noted in our previous reports, the Indian banking sector is still hindered by the stale public sector banks, and the more agile private banks are very well placed to take market share and grow profitably. By our assessment, the non-performing loan cycle is close to peaking. Trading at trough valuations, this company is attractively priced given its favourable growth trajectory ahead.

Commentary

India

On 9th November, the Indian government, in a bold attempt to fight counterfeit currency and, to a lesser extent, ill-gotten gains, announced without any forewarning the cancellation of the Rs500 and Rs1000 notes as legal tender (equivalent to A$10 and A$20). This so-called demonetisation exercise was an audacious move, as the notes being withdrawn represented 86% of the value of the currency in circulation. It was troublesome for those hoarders of cash, as swapping the notes would reveal their identity. For the real economy, the short-term impact on the still largely cash-dominated industries was also being felt, as ordinary people scrambled to swap their old notes for new ones and the system struggled to cope with the large volume of demand.

Anecdotal evidence coming out of the consumer sector is showing a rather dramatic slowdown, as seen in auto sales (down 7% month-on-month in November) and motorbike sales (typically a bellwether of the rural economy, down 15% month-on-month). Other indicators such as the Purchasing Managers' Index (PMI) and credit growth are also painting the picture of a sharp contraction.

Having said that, the peak in distress should have now passed, with over 80% of the Rs500 and Rs1000 notes banked and about a third of their total value dispensed in new denominations (via cash withdrawals from banks and ATMs) to provide liquidity to the economy. Despite the inconvenience, various surveys indicate that 80-90% of Indians support this move!

This is a short-term liquidity event, and once liquidity returns to the system, the extreme short-term loss of activity should quickly reverse, though the timing is difficult to determine. Given the declining trend in inflation, which has been exacerbated by the demonetisation, it is likely that the Reserve Bank of India will cut interest rates to mitigate the slowdown.

On the other hand, the move may potentially bring some major positives over the longer term. Through this exercise, the banking system has experienced a significant inflow of cash deposits. Assuming some of that remains within the banking system (i.e. not immediately swapped for cash in notes of other denominations), this should ultimately allow for the creation of more credit. Moreover, demonetisation is bringing a greater percentage of the population into the banking and taxation systems. As farmers, street peddlers and every other Indian deposit their about-to-be-obsolete cash with the banks, a significant portion of the fund inflow has been recycled by the banks into the government bond market.

The demonetisation has come at a significant time for India. The economy has passed through a prolonged downward cycle in capital spending and an accompanying credit cycle. A determined government is undertaking difficult reforms, such as legislating for a Goods and Services Tax (GST), introducing regulations to facilitate foreclosure on non-performing loans (for example, the banks were able to recover some funds from forced asset sales by defaulting borrowers such as the notorious Vijay Mallya's Kingfisher Airlines, Essar, and Jaypee Group), and the ongoing rollout of programs using the national ID scheme to prevent fraud in various government subsidy programs.

Our Indian bank stocks have been relatively resilient since the announcement of the demonetisation. Clearly the banks are benefiting from the inflow of funds, and there is downward pressure on interest rates. The consumer stocks, to which we do not have a significant exposure, have suffered bigger falls (they are generally the market favourites and much more highly rated), though indeed seem to be heading for a fairly sharp recovery.

China

We have witnessed a broad-based economic pickup in China in the second half of 2016. Further to the rise in power generation noted in our September 2016 Quarterly Report, power consumption and output continued to surge, rising 7% year-on-year in November, albeit, admittedly, from a low base. Recovery in construction machinery sales also kept its momentum from the July-September quarter. November excavator sales grew 75% year-on-year, 14% month-on-month. Heavy duty truck and engine sales grew 97% year-on-year for the month of November and 30% for the first 11 months of 2016. Diesel engine sales also saw an impressive 48% jump year-on-year in November. Stock prices of industrial companies like Weichai Power benefited significantly.

The all-important property market has recovered and stabilised over the last 18 months, with good clearance rates of vacant apartments in the larger cities, and that has led to an improvement in construction activity. Indeed, the property market in some parts of the country has been so buoyant that at the beginning of October policies were re-introduced to rein it in across 22 first- and second-tier cities. In cities like Nanjing and Hefei, inventory levels have dropped to as low as a supply of three months. These new policies attempt to curb speculative demand by restricting the number of properties that residents and non-residents are allowed to own respectively and by increasing the down payment home buyers are required to pay in order to obtain a mortgage. A subsequent slowdown has been noticeable and further tightening measures appear unlikely.

Some of the government's fiscal stimulus spending has been flowing into infrastructure. The number of public-private-partnership projects, which are predominantly infrastructure projects, rose from 30 in 2014 to 516 in 2016, worth more than a trillion yuan (approximately A$200 billion). Looking ahead, fiscal stimulation is expected to continue as 2017 will be an important transition year for China's senior leadership, and the country has capacity to do more given that its central government debt levels are relatively low and its fiscal deficit remains manageable.

The surprise for 2017 may be an improvement in profitability and investment by the private sector. A Producer Price Index (PPI) is an index that measures changes in prices received by domestic producers for their output. China's PPI has turned positive during the quarter, the first time since February 2012. This has come about due to improved demand, as noted above, and the success (though limited) achieved in excess capacity closure, which lent producers some ***pricing power***! PPI matters because it has significant linkages to China's economic growth, industrial profits, and stock market performance. For instance, with construction equipment sales down 50-60% from two years ago, the recent pick-up in building activity has led to a need to restock at the very least, with some producers even reporting tightening capacity.

We are seeing renewed concerns over RMB depreciation. As the country's economy adjusts to a slower growth pace, the Chinese currency is naturally experiencing depreciative pressure. The Australian dollar, for instance, also depreciated significantly against the USD because its economic growth has stalled as a result of China's slowdown. In an effort to control the pace of the RMB decline, the Chinese government has called on its foreign reserves and incrementally stepped up capital outflow restrictions. These measures entail increased scrutiny on companies making outbound investments and foreign property purchases as well as a crackdown on mainland Chinese tourists using their credit cards to buy insurance policies with a savings plan in Hong Kong. Whilst we acknowledge that capital flight is a real risk, which we are watching closely, we believe the policy response to date should help slow the pace of outflow.

Moreover, the direct impact of currency depreciation on China is limited. Given that most of China's debt is domestic, a fall in the Chinese currency will not significantly impact Chinese firms' ability to service their debt. The negative impact of tighter capital outflow will be felt more acutely outside of China in sectors that have benefited from the capital outflow in the past.

The new US President-elect and the team he has assembled appear to have a more protectionist policy outlook than the previous administration. Increased trade friction is a real possibility, but a major trade war will also negatively impact US exporters and consumers, and that will get in the way of their desire to "make America great again". Protectionist measures by the US will increase the Chinese government's determination to rebalance the country steadfastly into a more consumption-led economy.

The longer term outlook for China rests on the effectiveness of its reform efforts, which will be front and centre for Chinese policymakers in 2017. There is more progress on financial liberalisation, with the long-awaited Shenzhen-Hong Kong Stock Connect having commenced operation in December, following the 2014 launch of the Shanghai-Hong Kong Stock Connect. This new program opens up access to the domestic Shenzhen Stock Exchange by foreign investors while at the same time offers reciprocal rights to qualified domestic investors to invest in certain stocks that are listed on Hong Kong Stock Exchange. As the Chinese A-share market currently only has less than 2% foreign participation, compared to Asia's regional average of 30%, we see this as a positive step towards introducing more institutional investors with longer investment horizons into the A-share market which is currently dominated by local retail investors.

Recent announcements coming out of China's Central Economic Work Conference highlighted an increased emphasis on state-owned enterprise (SOE) reform, with six central government-owned SOEs been selected to participate in a mixed ownership reform pilot program through the introduction of strategic shareholders from the private sector. Historically, these SOEs have tended to deliver sub-optimal returns as they have often had to contend with conflicting objectives from different regulators. With more decision-making power now in the hands of their board of directors, together with the introduction of more market-oriented objectives for management teams, we may see these SOEs begin to behave in a more economically rational manner.

Korea

A political crisis is brewing in Korea. President Park was impeached in December following a series of scandals. One of her aides was reported to have been extorting money from the *chaebols* (Korea's powerful family-controlled conglomerates), claiming influence over the President. As a result, it is likely that the election will be brought forward from late 2017. An interesting investment implication is that the *chaebols*, anticipating reform pressure from a new government, may take it upon themselves to simplify their cumbersome corporate structures ahead of the election. Once reformed, it is expected that the interests of the controlling families will be more aligned with those of minority shareholders, leading to more shareholder-friendly policies, such as a higher dividend payout ratio and more frequent share buyback programs.

Outlook

The markets have been volatile, as the paths of reform are often not straightforward despite the rewards that lie ahead.

Government and private sector activities together should provide stability to the Chinese economy. Coupled with further efforts to close excess capacity, some improvements in corporate profitability and investment spending can be expected in the coming year. The Indian story is panning out largely as anticipated, and the likelihood of further interest rate cuts has increased, although the demonetisation exercise has led to temporary weakness.

There is a huge amount of activity happening in Asia, and our view is that the reform measures being pursued by policymakers are generally encouraging. Notwithstanding short-term turbulences, companies in the region with sustainable, competitive positions will likely prove to be worthwhile investments over the long run. Given that the markets have adjusted, the starting valuation for some companies is looking quite attractive. We will continue to deploy PAI's capital when suitable opportunities arise.

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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. 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 as a percentage of net tangible asset value.

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