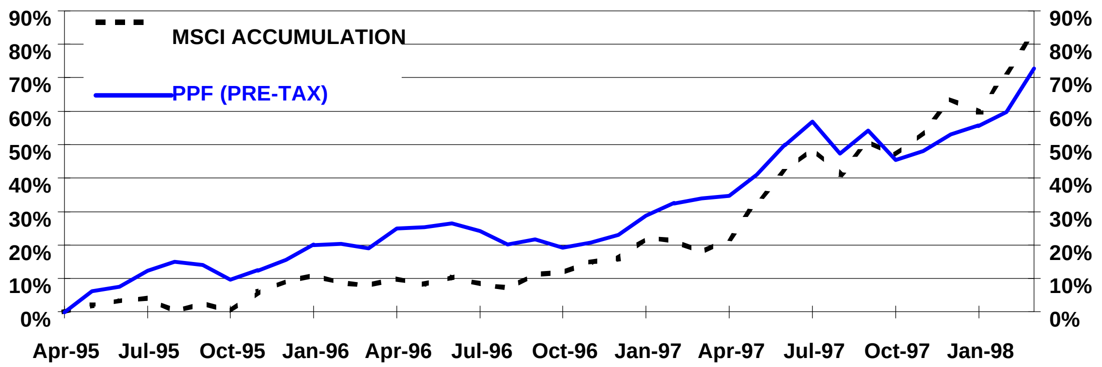
PLATINUM ASSET MANAGEMENT

Platinum Professional Fund

QUARTERLY REPORT
31 March 1998

Performance

It has been a tearaway quarter led by Italy and France. Facing the same hunger for yield witnessed in the States, Italy surged 34% (in A$ terms) with the major European markets typically appreciating by 15%. Irrepressible Wall Street wasn't far behind, achieving 12%, and while Japan offered a strong start to the year, it fizzled out and was left virtually unchanged. This led to a weighted increase in world markets (MSCI) of 12.3%. With a return of 12.9%, we were pleased with the performance from the portfolio given the built in protection of our cash and continuing short position on Wall Street.



PPF Cumulative Performance versus MSCI World Accumulation Index

Changes to the Portfolio

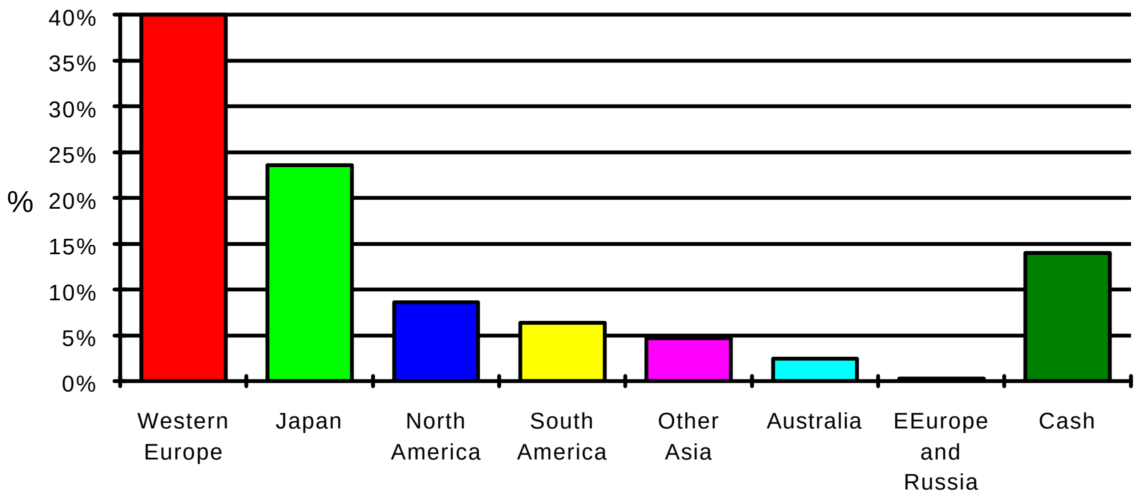
The blistering pace of market appreciation caused some of our European stocks to exceed our target prices and we were obliged to sell. We cut our entire holdings of Nestlé, Accor, Canal Plus, IFI and AMGA, as well as trimming back on several others. We were also active on the purchase side introducing new holdings such as Valora (kiosks and mattresses), Douglas Holdings (retail), Deutsche Telekom, Pernod Ricard, Continente (supermarkets) and WPP (advertising).

Early in the year the strong performance in Japan caused us to reduce our position, selling out of Asahi Breweries, KAO, Banyu and Taiyo Yuden and trimming others. We also trimmed some Korean holdings which have more than doubled since December. Other significant changes included the addition of Qualcomm (mobile communications) and casino stocks in Australia (temporarily depressed by falling tourism).

Top Ten Holdings (as at 31 March 1998)

Stock	Country	Industry	Holding
Rinascente	Italy	Retail	5.0%
Swiss Industrial Group	Switzerland	Packaging/Engineering	3.0%
Fuji Photo Film	Japan	Photographic Equipment	2.7%
Acuson	USA	Medical Equipment	2.6%
Valora	Switzerland	Retail/Distribution	2.6%
Mikuni Coca Cola	Japan	Bottler	2.5%
Lagardere	France	Media/Defence	2.4%
Yamanouchi Pharm.	Japan	Pharmaceutical	2.3%
Canon	Japan	Office Equipment	2.3%
Daiichi Pharm	Japan	Pharmaceutical	2.2%
TOTAL			**27.6%**

Disposition of Assets



Commentary

We have just completed an extensive tour of South East Asia visiting Malaysia, Thailand, Singapore, the Philippines and Hong Kong. The objective was to try to find those firms that may look sad at present and yet could be the great growth franchise stocks over the next five years or so. The pattern was to see a broad range of companies from property stocks and banks (to measure the degree of property over-supply and hence credit quality), to industrial companies with interesting business economics. Having seen 51 companies and various specialists, we arrived home with a surprisingly empty net. The problem - which we alluded to in our last communication - is the high valuations being given to the leading companies in each market. However, in nearly every case these larger companies so enjoyed the good times that they forgot about the obligation that accompanies heavy use of debt.

The most striking example of excess was in Bangkok where the two leading banks accounting for some 35% of the system have non-performing loans that may amount to 30% of their loan portfolios. This implies that they are technically insolvent and yet, international investors have been prepared to refinance one of these banks (Thai Farmers Bank) with close to US$900 million. This deal was priced at twice adjusted book value and evaluated on the historic lending spreads of 4%. Both of these assessments are tinged with optimism. Bangkok Bank is planning a similar placement to international investors which will be good for both the company and obviously for the broader financial system in that country. This cannot, however, address the vast over-supply of property upon which the whole banking system relies for collateral. With deteriorating property values, the ability of the system to extend credit (and indeed generate good cash flows) is very limited and hence the prospects for the economy are poor at present even after the devaluation of the baht by 40%.

Having sought out hotel companies as being natural beneficiaries of the devaluation (being essentially export businesses), we were somewhat alarmed by the choice of properties we were offered during a Saturday excursion around Bangkok. Hotel properties (along with residential and serviced apartment buildings) are available at around replacement cost. This is less than the equivalent value placed on listed companies in the stock market. Worse still, the level of prices and the fact that one is still dealing with the owners of the properties rather than the mortgage holders, highlights that the process of liquidation is still in the early stages. (insolvency law makes foreclosure a very cumbersome procedure and gives little extra protection to the principal mortgage holder versus the rest). It is ironic that in an economy where the banking system is technically insolvent, that there have still been no major bankruptcies among leading industrial companies.

Moving on to Kuala Lumpur, we witnessed the same excess with the recently completed twin Petronas Towers, the tallest building in the world (offering 2.4 million square feet of office space) epitomising the boom mentality. The excitement and optimism was at an extreme with capacity being added principally with an eye on capital appreciation rather than recurrent income. As one property agent put it, "local investors didn't spend much time studying form" and he noted that whenever the question of yield was raised, it was never from a local developer. The projected amount of new supply is put at 22 million square feet versus an existing prime stock of around 30 million square feet. This will create a serious overhang in a city which normally has take-up of 3 million square feet per year, even if many of these buildings remain half completed. Indeed we were told that some owners were slowing their construction programs; on one site we spotted a lone worker - 30 floors up!!

This pattern of property over-supply emerged in each country to a greater or lesser extent. There are the same important implications for collateral values and the banking system, with non-performing loans ranging from 30% in Thailand down to 15% in Manila. At the same time, interest rates are being kept high to support their currencies which exacerbates the liquidity squeeze. Hong Kong has by far the most fluid property market with transactions quickly adjusting prices. Residential prices are typically off by 30%. The stability of the dollar peg however has had its adverse implications for this service based economy. Tourism has crumbled, hotel occupancy dropped, and the retail scene imploded with most clothing retailers experiencing declines in sales of anywhere between 10-30%.

Although the large Hong Kong residential property developers are mostly financially sound, their earnings will be very weak for a couple of years. At the margin, there were the up-and-coming developers who bid aggressively at the government's land auctions, and now find that the prices they paid in terms of "accommodation value", exceed the current selling price of completed buildings. To foreigners, these prices still seem exorbitant running at US$8,000 per square metre implying that a small flat would cost close to a US$1 million. A nice touch, and indicative of the property-centric nature of Hong Kong, is a facility to use one's mobile phone to find the latest residential property prices. This service is available along side that of stock quotes.

The point of labouring the issue of property supply, is that the consequential loss of lending capacity by the banks, and indeed their willingness to lend, will greatly impede economic recovery. Even now exports are proving slow to recover in the face of massive devaluations with buyers preferring to rely on China rather than fight with suppliers burdened with working capital constraints. There are a few short term stimuli to re-energise these ASEAN economies. The weakness in Japan, which takes around 40% of the region's exports, is no help at all.

Tales of cutbacks abounded with, for example, a leading building material supplier preparing for a volume decline of 30-50%. Soft drink bottlers are tentatively putting up their prices by around 15% and yet their input costs are rising faster (eg. Aluminium can costs up by 30%+). Retailers are walking away when leases come up for renewal in Hong Kong and some even when rents are set 30% below former levels. Most difficult to gauge of all is the likely impact on employment levels. It is only now that layoffs and repatriation of foreign workers is starting. Over and above this adjustment to poor demand and rising costs versus sticky selling prices is the prospect of fresh competition. This comes in the form of multi-nationals prizing open markets in the wake of IMF imposed deregulations or simply acquiring market share by buying troubled companies.

On the subject of China, the emergence of Zhu Rongji as the new Prime Minister is of great significance. Following the same pattern he pursued as Mayor of Shanghai he seems to be pushing ahead with the supply-side reforms. Priority has been given to tighter State administration, and heavy expenditure on infrastructure and housing. However, it is a very narrow path that is being walked. The significant shake up of the banks and State owned enterprises is resulting in a major loss of jobs. At the same time, the great flood of inward investment and massive explosion of exports which fuelled the booms of the late eighties and early nineties, is now waning. With its vast internal market and high savings rate, this may in itself not be insurmountable but the target of 8% growth in this period of adjustment seems optimistic. Growing unemployment will require careful handling as the country needs the creation of no fewer than 20 million jobs per annum for a stable employment market. Talking with companies which have manufacturing operations in China, it was reassuring to find that their labour costs were unchanged on five years ago - as they simply add workers from outside the coastal provinces. (A typical factory worker may earn around US$100 per annum plus dormitory accommodation and a meal a day). Combined with comments made by others around Asia, this suggests that the loss of competitiveness vis-à-vis their ASEAN rivals, is not overwhelming.

Let us go back to the companies we liked. The true growth companies that will ride out the recession in Asia are no cheaper today than they were before the crisis. Regional funds with dedicated portfolios have treated these as places of refuge. Of much more interest to us are those companies which are experiencing some indigestion as they complete longer term projects that happen to coincide with the downturn but where demand for their products will grow anyway. We shall be watching these closely over the coming weeks with a view to acquiring positions. We shall avoid those companies which the market is pricing on the basis of ASEAN economies having a rapid recovery.

Outlook

The most illuminating observation of market behaviour in the last three months is the way the seemingly dysfunctional markets of Italy and France have performed. Just prior to year-end, criticism of the inflexibility of these markets reached a crescendo only to find that within three months they have outperformed most comers. This is perhaps the lesson going forward that just now as we see Japan at its weakest and most inflexible, the stock market is adjusting downwards and possibly entering an interesting level for asset allocators.

Looking forward, the US market looks totally unstoppable on the tidal wave of liquidity which is seemingly also now driving Western Europe. We should be aware though that investor psychology is changing. In recent weeks even several companies that have produced disappointing results, have been forgiven within days, if punished at all, to reach new exalted heights. Our travel through Asia constantly reminded us of excessive investor optimism where the purchase of assets was driven purely from a speculative view on capital appreciation rather than an appraisal of the existing cash flows. As we have noted in previous commentary, the probability of many companies achieving projected earnings growth similar to that of the last few years, is very low and hence disappointment is likely.

We remain committed to seeking out those companies which have attractive growth prospects and where prices make allowance for future uncertainties.

Currency

We continue to remain hedged out of the yen and partially out of our European exposures.

Stock Story - Rinascente (Italy)

Rinascente is a multi-format Italian retailer. The core of the business is food retailing (80% of sales) through a chain of hypermarkets (stores of roughly 7,000-10,000sq.m.) and supermarkets (stores of a few thousand sq.m.). In addition, Rinascente operates department stores, DIY (home/hardware) outlets, and a chain of variety stores.

The Italians refer to a concept called “modern retail” when the subject of hypermarkets is discussed and this uncomfortable term illustrates the archaic nature of food retailing in the country. Italy has the highest number of shops per capita in Europe - reflecting the success of owner operated “mom’n’pop” stores to hold off large scale “modern” retailing chains. The association of shop owners is very powerful and has in the past been politically protected by the maintenance of astonishingly complicated laws governing licences to open large format retail outlets. For this reason the numbers of hypermarkets (and large, competent supermarkets for that matter) in the country is very low relative to obvious comparisons such as France and Spain.

Another restraint for Rinascente in the past has been poor operational management - the 25 hypermarkets which they have been operating display sales densities (ie sales per sq.m. per year) far lower than their counterparts in France. Profitability has been very poor. This is despite the relative affluence of the (northern) Italian consumer and the virtually non-existent competition (versus the oversupplied and cutting edge competitiveness of the French market, for example). Rinascente profits were basically flat for the several years up until 1997 and despite the fabulous potential for the company (all the best European operators' principal desire for several years has been to break into the Italian market) the stock market had little interest in the shares.

Little interest, but not no interest. What was clear was that the company was an extremely interesting take-over target for someone like Carrefour, Auchan or Tesco who were searching for an entrée into the market but needed some critical mass to avoid the years of losses involved with battling the small storekeepers' lobby. (Indeed Auchan had been trying to get established for years and had managed to open only 4 hypermarkets). The trouble was that the Agnelli family (of FIAT fame) holding company, IFIL, owned a large enough stake in Rinascente to prevent a hostile take-over.

A stunning opportunity (and a wonderful illustration of the occasional short term focus of stockmarkets) came up in June last year. We had visited Rinascente in April and left thinking that while the position was interesting the operational management was not capable of really capitalising on their hypermarket leadership and with a still dull consumer environment the stock was about the right price (L10,000 per share or so). A few weeks later a deal was struck between the Agnelli clan and the French company Auchan (a very successful hypermarket operator based in France but active around the world) whereby they created a joint venture which would own the Agnelli Rinascente stake. In addition Auchan put their four Italian stores into the business and assumed operational control of the food retailing side of Rinascente. At a stroke the Agnellis had added the key ingredient the business had been lacking - expert operational management. However in the stockmarket's eyes, this deal removed, at a stroke, any chance of a take-over and gave the "control premium" (Auchan paid the equivalent of L14,000 to IFIL for their stake) only to the Agnellis and not to the minority shareholders of the stock. In disgust the stockmarket sold the share down 20%.

Hence the opportunity - a strong but stagnating position had just been transformed by the input of hypermarket management head and shoulders above the rest of the Italian retail scene. Suddenly the story was interesting - the miserly profitability would likely be multiplied several times and the best potential in European retailing was beginning to be unlocked. And the market took 20% off the shares!!! We bought as much stock as we could between L8,000-9,000, and then fully subscribed to the rights issue in the shares which was being held to fund future expansion.

A visit to the company's headquarters outside Milan a few weeks ago was a stunning contrast to the discussion we had had less than a year earlier. A turnaround in consumption in Italy in recent months, and good restructuring efforts in the non-food side of the business have given a boost to sales and profitability of the whole operation. But more impressive was the wonder in the company representative's voice as he discussed the "Auchanisation" of the hypermarkets. It was the reaction of someone who has been shown for the first time the difference between "retailing" (ie selling) and "distribution" (ie merely acting as a passive link in the manufacturer-consumer chain). As this transformation takes place over the next 18 months we should have a food retailing offer which is largely without peer in Italy. It is hard to imagine that the business will not see the sort of improvement in sales densities being targeted; operating profits should also see a dramatic uplift.

The risks to the story are that store openings will continue to be difficult (this is actually a blessing as well as it prevents someone like Carrefour opening dozens of stores over a few years and providing serious competition) and that the plan of 2-3 new stores per annum will be unachievable. However the whole approach to vested interests in Italy has changed in recent years with the run-up to EMU and it is scarcely conceivable that the retail scene will be kept in the dark ages.

The stock has performed well as the market has come to appreciate the fact that operational management is good news rather than simply focusing on the disappointment of there not being a full take-over. Also of course we have the helpful improvement in consumption in Italy and a bull market to boot. By the end of March the stock had moved to L19,500. Thus we would say that for the moment the stock has run ahead of the story. However we anticipate that in coming years this can be a very interesting investment even from these levels as the business starts to produce sales and profit figures far above what seems imaginable today.

Kerr Neilson
Managing Director
9 April 1998