Investor Letter
August 2023

“We should invigorate the capital market and boost investor confidence.”

China’s Politburo, July 2023

Dear Fellow Investors,

For the twelve months ended 30 June 2023 (FY23), Regal Asian Investments Limited (ASX:RG8) generated a net portfolio return of +8.3% after all fees with an average net exposure of 64%[1]. The share price of RG8 increased +16.8% over the period, with the Company declaring and paying two semi-annual dividends through FY23, which total $0.10 per share.

Inclusive of dividends paid and share price appreciation, RG8’s total share price return for FY23 was +22.8%.

An active on-market buyback program was maintained through FY23, providing the dual benefits of increased liquidity and the accretive effect of purchasing and cancelling shares at a discount to the current NTA. RG8 purchased 19.9m shares over the period, at a total cost of $40.1m.

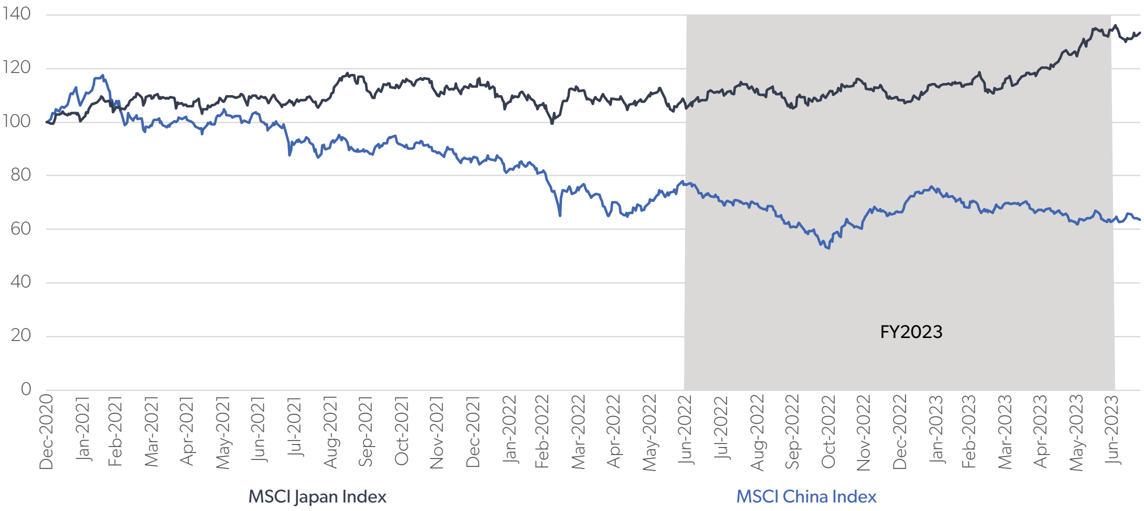
As at 30 June 2023, the RG8 portfolio size was $443m, encompassing long and short positions in securities with exposure to the Asian region. The portfolio held a long exposure of 115%, a short exposure of -34% and total net exposure of 81%. The average weighted market capitalisation of companies held in the portfolio was US$40.7 billion.

In June 2022, portfolio management responsibilities for RG8 were transitioned to Regal Funds Management, with FY23 representing the first full-year of performance under the Regal team.

MARKET OBSERVATIONS

For FY23, the MSCI Asia Pacific All Country Index (local currency) returned +10.1%. While a strong result, the headline number largely masks the significant divergence in returns across Asian markets through the period, with none more notable than the disparate returns generated across the two largest contributors to the regional index, China and Japan. For the 12 months to 30 June 2023, the MSCI Japan increased +25.7%, while the MSCI China Index declined -16.7%, extending the continued underperformance of MSCI China in recent years, per the graph below.

Index Performance - Rebased to 100 as at 31 December 2020

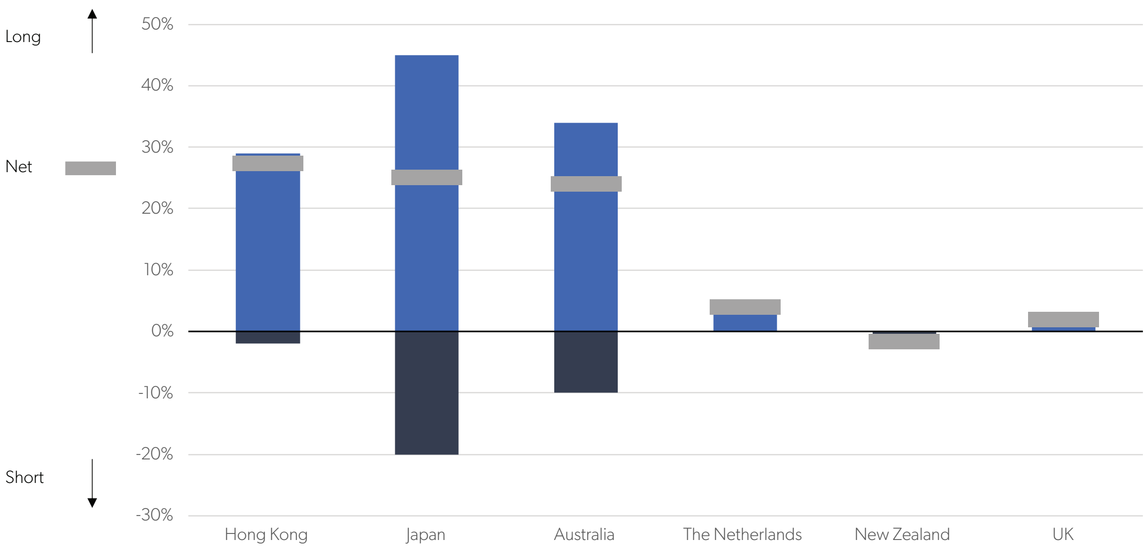


Source: Bloomberg

1 Past performance is not a reliable indicator of future performance and should not be relied upon as an indication of the future performance of any fund or strategy

In our construction of a concentrated portfolio of long and short investments with exposure to the Asian region, the RG8 portfolio currently holds positions across both the Japanese and Hong Kong equity markets, with a common theme across these holdings being the attractive combination of low valuations and a recent shift by management teams toward unlocking hidden value. At present, our China-facing exposures largely consist of long positions in heavily undervalued Chinese technology businesses, via listings in Hong Kong and the Netherlands (including Prosus NV, which we will discuss later in this letter), while our Japanese investments include companies we identify as global leaders with sustainable competitive advantages that are leveraged to structural demand growth across Asia. The portfolio also retains a net long exposure to Australia, focused on companies with high quality assets that will benefit from Asia's growing demand for energy and materials, as discussed in our prior communications.

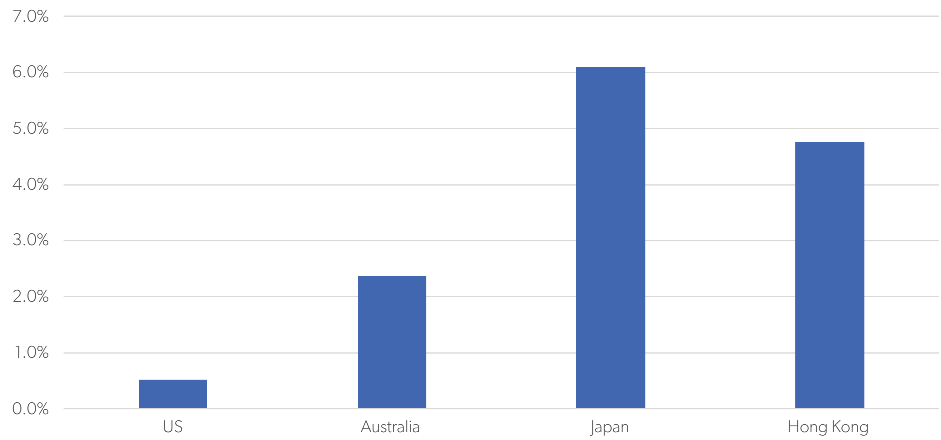
Portfolio Positioning By Market



Source: Regal Funds

As per the chart below, both the Japan and Hong Kong markets offer investors extremely attractive equity-risk-premia at present, as represented by the corporate earnings yield (or inverse of price-to-earnings) in excess of the risk-free rate of that country (or 10 year government yield). We find both Japan and Hong Kong to be appealing hunting grounds for our highly selective and concentrated bottom-up portfolio of stocks, for reasons outlined below.

Equity Risk Premium



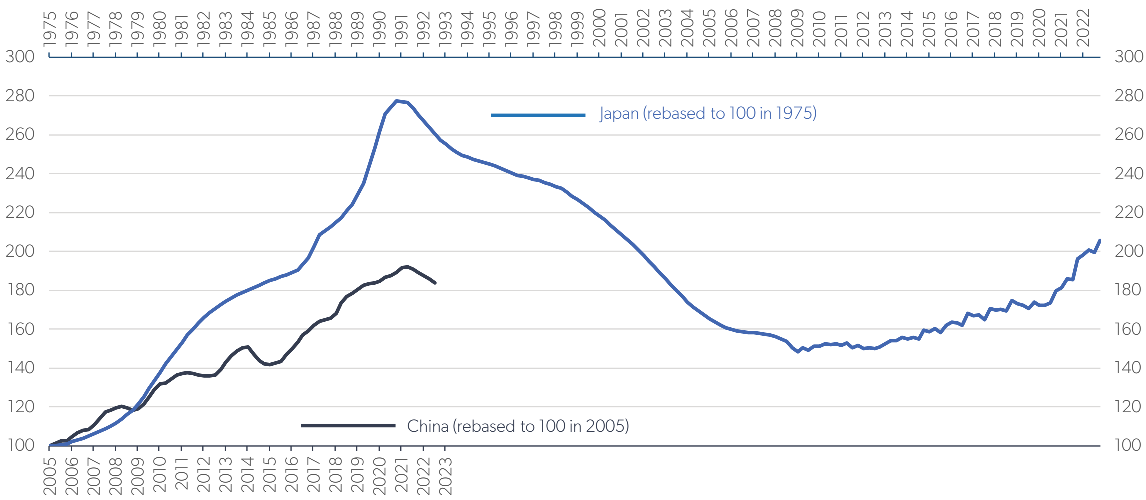
	US	Australia	Japan	Hong Kong
Corporate Earnings Yield	4.6%	6.5%	6.5%	8.6%
10 Year Government Yield	4.0%	4.4%	0.6%	3.9%
Equity Risk Premium	0.6%	2.4%	5.9%	4.8%

Source: Bloomberg

CHINA

One of the biggest questions facing Asian investors is whether China now faces similar economic challenges to those seen by Japan after its property market peaked in 1990. We see both similarities and differences between the two, with the largest difference being that of stock market valuations. Put simply, we believe China is unlikely to suffer an equity bear market similar to the Japanese experience of the 1990's, given the already highly suppressed valuations. To the contrary, we agree with the Chinese authorities increasing messaging that the stock market could be part of the solution rather than part of the problem. The equity market can facilitate the raising of capital by new advanced industries in areas such as artificial intelligence, advanced semiconductors and renewable energy. Additionally, it can help legacy indebted entities improve their balance sheets, address funding shortfalls within China's pension system and enhance consumer confidence amongst various other broad-based benefits.

Residential Property Prices



Source: BIS

Another commonly mentioned similarity is China's demographic outlook, which is facing the same aging and declining population challenges that Japan has experienced in recent decades. Some argue that demographics could have a larger impact in China as the population is now peaking at the same time as its residential real estate market is showing signs of weakness. Japan's population, meanwhile, did not peak until nearly two decades after its property bubble burst.

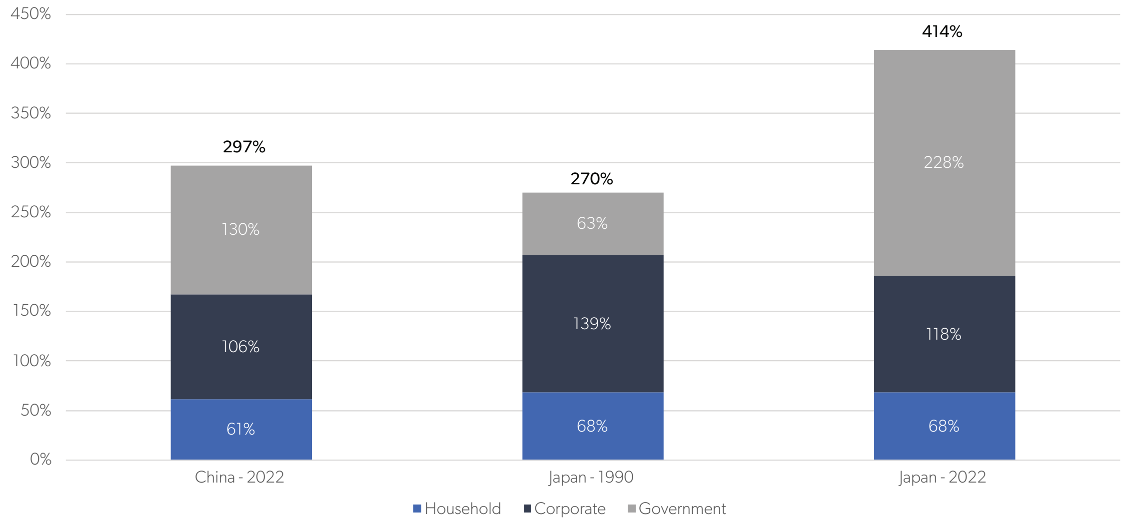
Total Population (mn)

Source: UN Population Forecasts

There are demographic differences that mitigate these concerns to some degree. For example, China has more room for its urbanisation rate to continue to rise from its current 65% towards the 77% seen in Japan in 1989 and then potentially above 90%, as seen in Japan now and many other advanced economies. China also has more room for its middle-class to continue to expand and its GDP-per-capita to rise from its current US$13k versus the US$25k for Japan in 1989 (or US$49k in today's dollars, according to Morgan Stanley).

Another parallel to Japan in 1990 is undoubtedly China's high-debt levels. China's total debt-to-GDP ratio is higher now at 297% compared to Japan's debt-to-GDP of 270% in 1990. However, China has less corporate and household debt as a percentage of GDP, and China's corporate sector has been deleveraging since 2017. In comparison, a lot of the debt in Japan resided in listed companies which weighed on the stock market in subsequent years.

Debt to GDP Comparison

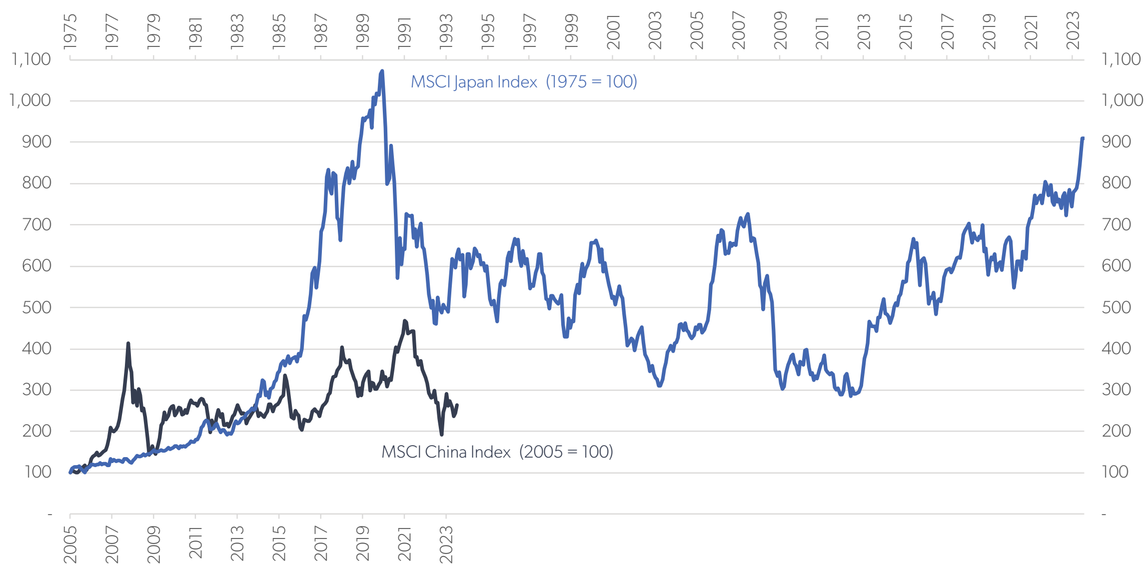


Source: BIS, IMF. Excludes financial institutions to avoid double counting

Note: China corporate debt and government debt have been adjusted so that Local Government Funding Vehicle debt is allocated to government debt

In terms of the critical differences, the most important from an equity investors, perspective, is that China's stock market has not risen by anywhere near the same amount as Japan's did in the period leading up to 1990. In fact, the MSCI China Index is currently trading at a similar level to where it was five years ago, ten years ago and 15 years ago, whereas the Japanese stock market experienced a huge ten-fold increase in its stock market in the 15 years prior to its property bubble peaking in 1990.

Price Index Over Time



Source: Bloomberg

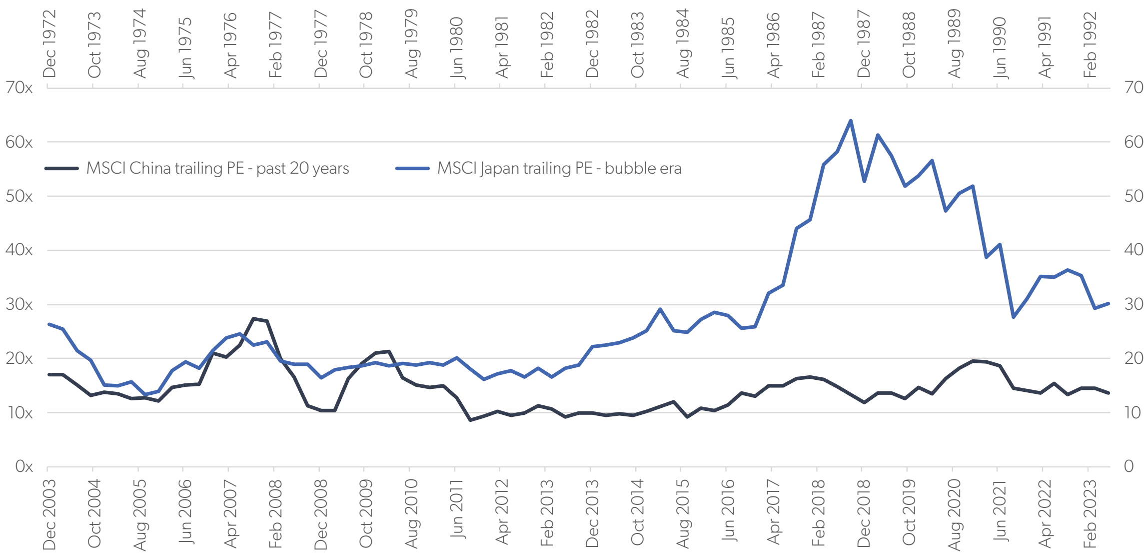
Chinese equities have already seen a substantial sell-off in recent years, of a similar scale as that seen in Japan in the years immediately after its bubble burst. That is, despite the China market starting its sell-off from a far lower comparative base. We particularly feel that investors in Hong Kong listed equities, which make up the majority of the MSCI China Index, have already capitulated, which in our mind creates selective opportunities to invest in undervalued securities.

Price Index Over Time

Source: Bloomberg

China's stock market is far more attractively valued than Japan's was around its real estate peak. Japan's MSCI Japan Index at the peak traded on a trailing price-to-earnings of over 60x and still traded at 30x in 1992 well after the initial equity market correction. It took decades for Japan's equity valuations to correct to the attractive levels we see now and discuss later.

Trailing Price-to Earnings Over Time



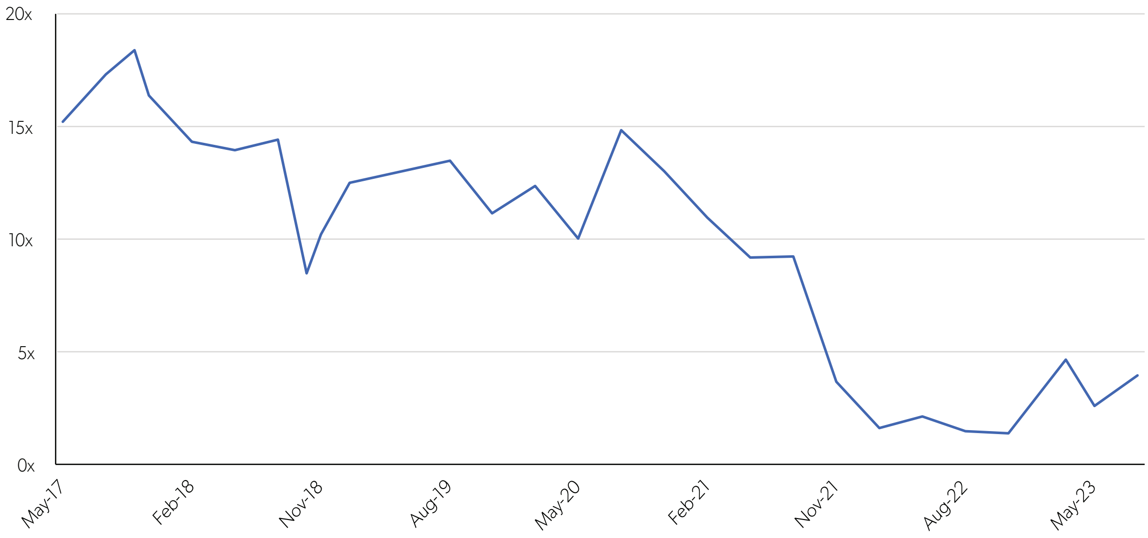
Source: Bloomberg

Looking at simple price-to-earnings ratios in China can also miss the true opportunity hidden within some of its leading technology platforms. One way to account for the full value of a company is via sum-of-the-parts analysis which factors in not only the current earnings but also any non-core businesses which could be near-term loss making but have long-term value, investment portfolios and net-cash.

We have taken an alternative approach to visualising this in the charts below. Here we reverse engineer the price-to-earnings multiple one would need to ascribe to the core business for a sum-of-the-parts to equate to the current market price (i.e. after backing out the value the of other parts what is price-to-earnings is the core business trading on). We use Goldman Sachs reported sum-of-the-parts assumptions over time which allow us to look back at how this measure has changed over the last five years.

Alibaba Group is a particularly interesting example to look at following its management very publicly declaring their intention to "unlock the value" hidden within its expansive corporate structure by spinning-off a range of non-core assets. In theory, if Alibaba Group were to spin-off all of its non-core assets in a tax efficient manner and return the value to shareholders, the remaining core "China Commerce" segment (including China's largest e-commerce operation) would be trading on around 4.0x price-to-earnings (using Goldman Sachs sum-of-the-parts assumptions). While this certainly could be considered an optimistic scenario it is an interesting exercise to highlight the potential value that management is trying to unlock.

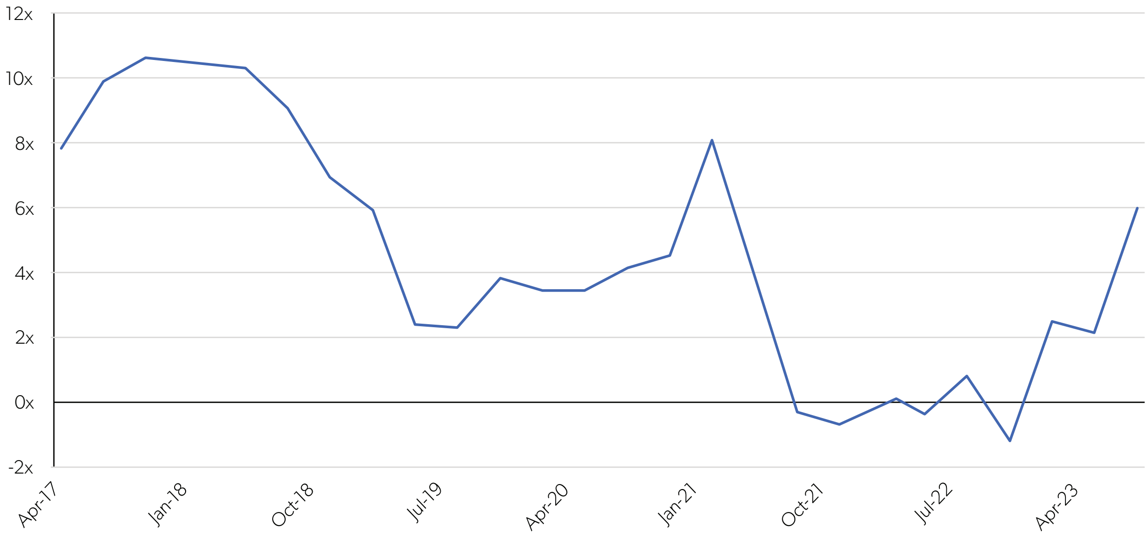
Alibaba Group: Implied Price-to-Earnings Ratio of the Core "China Commerce" Business



Source: Regal Funds calculations, adapted from Goldman Sachs SOTP. July-August P/E calculated using most recent SOTP, and current market capitalisation

When we initiated our long position in Baidu Inc late last year its stock price was trading below the value of just its non-core business components, (if we reverse engineered Goldman Sachs assumptions at the time). In other words, Baidu Inc's core "Search" business, which is China's leading internet search engine, was effectively being valued on a negative price-to-earnings. While the stock price has since risen, such that it is now implying a 4.9x price-to-earnings for the core search business, we have also become increasingly positive on Baidu Inc's earnings outlook as a leading player in China's artificial intelligence (AI) development. The company not only has the most advanced Large Language Model (LLM) in China, on a number of important measures via its ChatGPT equivalent ErnieBot, but also has advanced proprietary semiconductor chip technology and has the leading deep learning framework. Baidu's AI advancements are likely to accelerate the growth rates of its core search business, via new innovations such as AI generated gift recommendations, AI travel planning, AI fashion apparel pairing, AI home décor matching and numerous other applications. Moreover, Baidu Inc can enhance its leading business-to-business AI cloud service ecosystem with a customer base of over 200,000 enterprises currently utilizing its deep learning framework. Again, while the assumptions below could be considered as optimistic in the near-term there is clearly significant potential value to be unlocked.

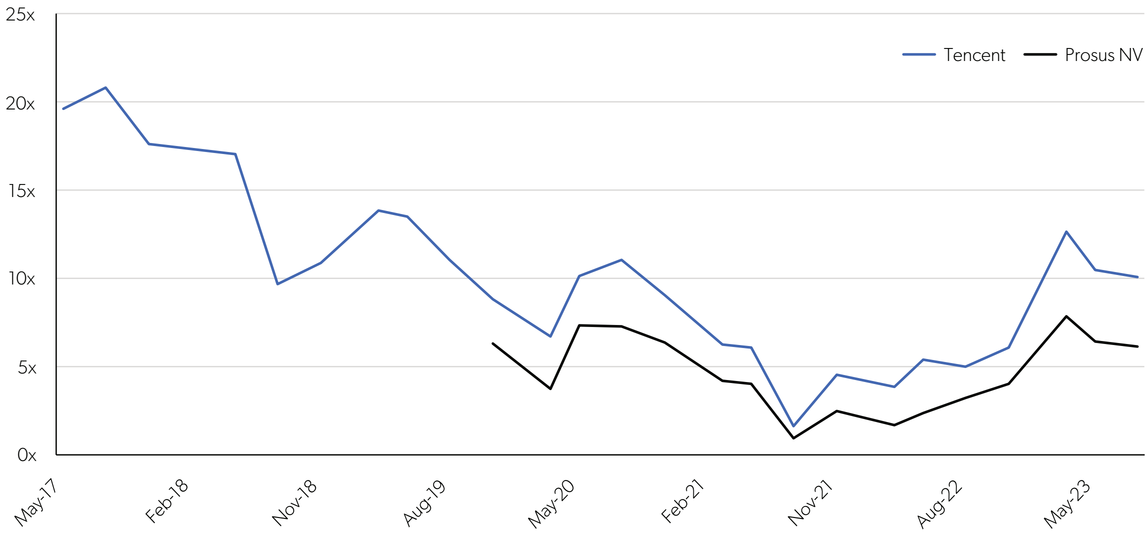
Baidu Inc: Implied Price-to-Earnings Ratio of the Core China "Search" Business



Source: Regal Funds calculations, adapted from Goldman Sachs SOTP. July-August P/E calculated using most recent SOTP, and current market capitalisation

The implied price-to-earnings of Tencent Holdings' core business, which includes leading entertainment and advertising platforms in China, has risen significantly over the last year. We recently shifted most of our holding from Tencent's own Hong Kong listing towards Prosus NV, which is listed in the Netherlands. Prosus NV's early investment in Tencent has grown to become its largest asset. Prosus NV meanwhile trades at a substantial discount to its own sum-of-the-parts which we reflect in the chart below showing that in our view it is a more attractive way to invest in Tencent Holdings, particularly given Prosus NV's management led efforts to close its discount. This includes a recent restructuring and an ongoing stock buy-back program.

Tencent Holdings and Prosus NV: Implied Price-to-Earnings of Tencent's Core China "Entertainment" and "Advertising" Businesses



Source: Regal Funds calculations, adapted from Goldman Sachs SOTP. July-August P/E calculated using most recent SOTP, and current market capitalisation

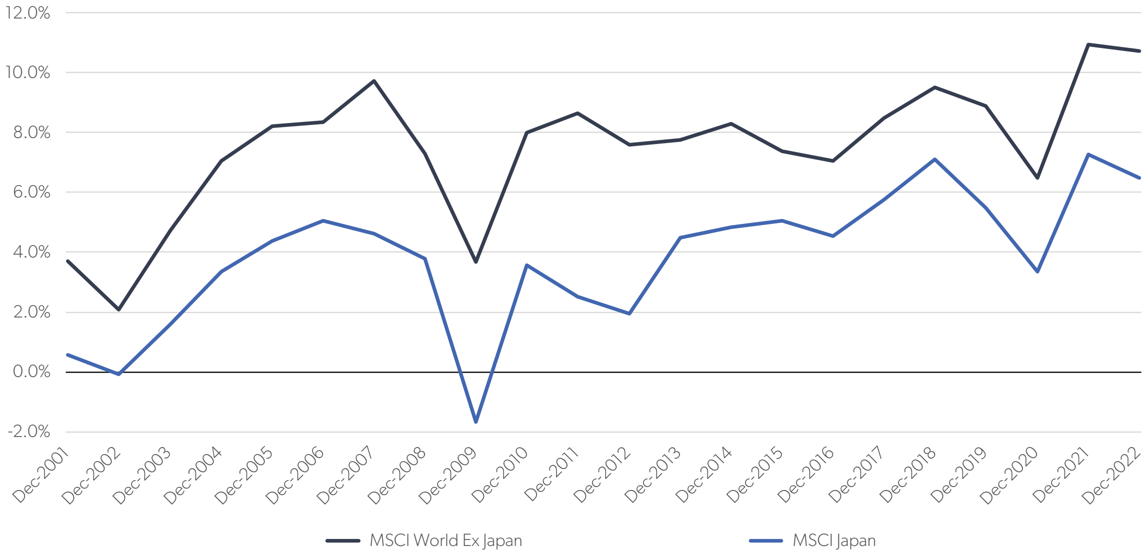
These are just some of the examples of investment opportunities we see in growing Chinese companies that have sustainable competitive advantages but are trading on extremely low valuations and have significant value to be unlocked.

JAPAN

Our investments in Japan continue to be focused on companies that are global leaders in their field, have a sustainable competitive advantage and are leveraged to structural demand growth across Asia.

Overall, the outlook for investing in Japanese listed equities has improved significantly this year amidst a broad-based drive towards improving returns for shareholders. Historically, Japanese companies have not focused as intensely on profit margins and shareholder returns as some of their international peers. This ties in with Japanese customs of seeking harmony, or "Wa" (和), whereby the interests of all stakeholders are balanced out. This can lead to Japanese companies over-servicing customers or protecting employees in loss-making business units which can lead to lower margins.

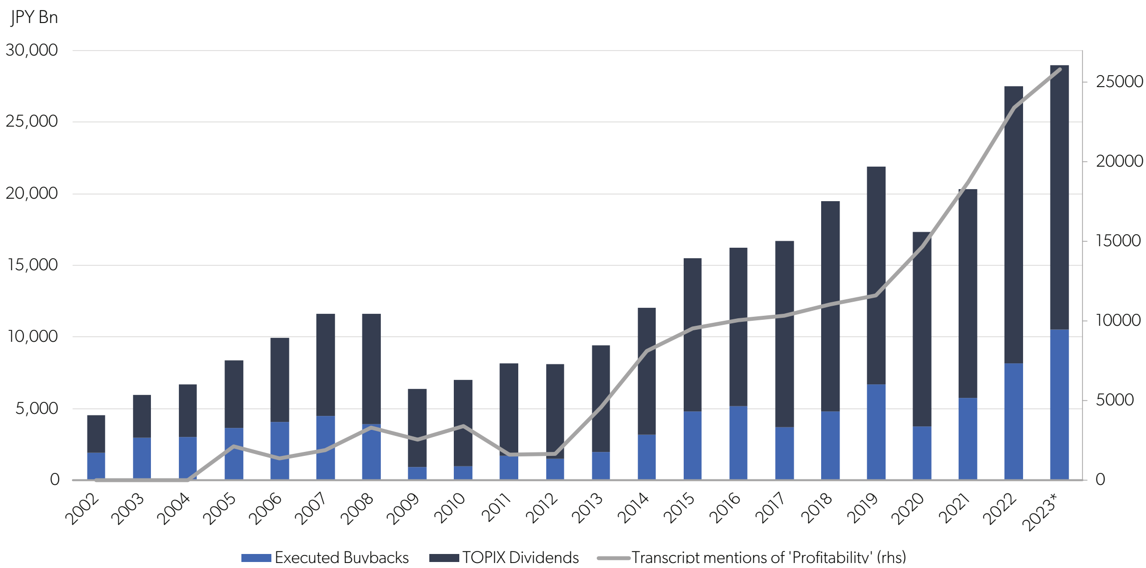
Profit Margins



Source: Bloomberg

In the chart below we can see a striking increase in Japanese corporates discussing "profitability" in their earnings calls. Japanese corporates have also long been criticised for excessive net cash hoarding, which comes at the expense of lower shareholder returns and lazy balance sheets that drag down return-on-invested-capital. In recent years we have seen an extremely positive trend towards higher shareholder returns via both dividends and share-buybacks. We look forward to participating in further increases, towards global shareholder return ratios.

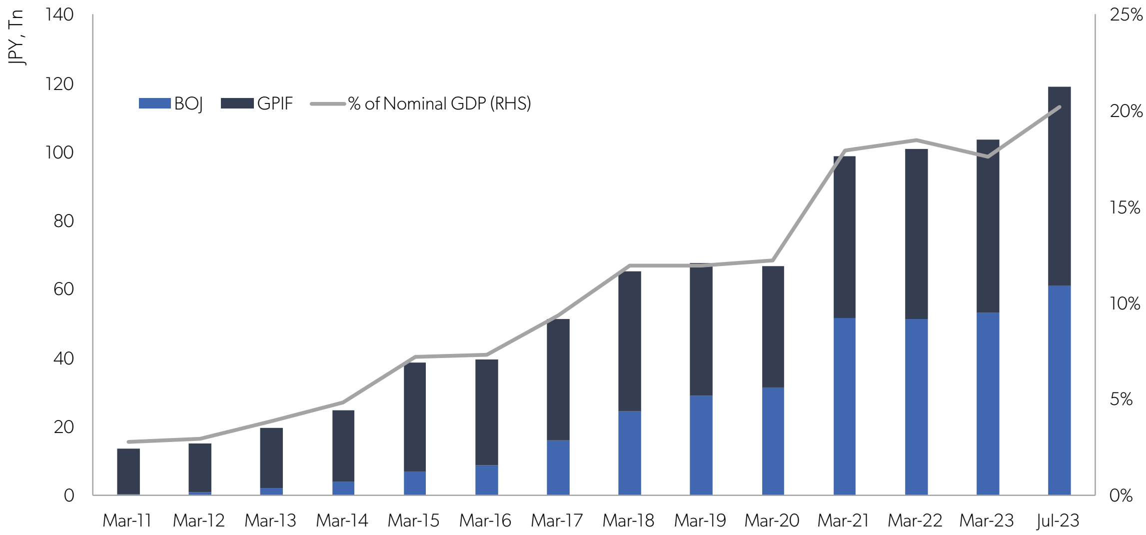
Japanese Capital Management Soaring as Management Adopts a More Profitability-focused Mindset



Source: Nikkei NEEDs, TSE, AlphaSense, Bloomberg, Factset, Morgan Stanley Research. 2023 numbers are annualised

A key driver behind Japan's dramatically improving margin and shareholder return focus is government pressure towards companies. This has coincided with a rise in public ownership of equities via the Government Pension Investment Fund (GPIF) and Bank of Japan (BOJ). Combined, these entities now own stakes in Japanese companies, on behalf of the Japanese people, worth over 20% of Japan's GDP. The government is now more than ever incentivised to ensure the people of Japan are adequately compensated for their pension investments in Japanese corporates.

Japan: Market Value of Domestic Equity Holdings



Source: GPIF, BOJ and Bloomberg

Like China, we see hidden value below the surface in many of our Japanese investments and again using simple price-to-earnings multiples can often miss the true value. In our recent webinar, we discussed Toyota Industries as an example of a Japanese business with holdings in other listed entities that are worth more than its own market capitalisation. Applying a sum-of-the-parts methodology – this time using market prices for non-core assets – implies investors are paying a negative price-to-earnings ratio for Toyota Industries' core businesses. Toyota Industries meanwhile is a global leader in warehouse automation and electric vehicle components, two areas that we are extremely positive on.

Ferrotec Holdings is a slightly more complex situation. At its core, Ferrotec Holdings is a comprehensive provider of consumable materials used in semiconductor production, including high purity silicon, quartz, and ceramics. It also provides electronic-vehicle related power-semiconductor substrates, semiconductor parts cleaning and is the global leader in ferrofluid technology used in polysilicon production processes. This diversified product portfolio, with market leadership in many areas, has allowed the company to develop strategic relationships with several semiconductor industry leaders.

Ferrotec Holdings trades on a highly appealing 8.3x price-to-earnings based on analyst consensus for its next twelve months. However, Ferrotec Holdings' full valuation upside potential is amplified by its plans to IPO three of its unlisted Chinese subsidiaries: CCMC (specializing in silicon wafers), FTNC (offering quartz crucibles and silicon parts), and FLH (focused on power semiconductor substrates). These subsidiaries are expected to list in China where they are likely to achieve high valuations thanks to their prestigious global semiconductor clientele, the types of investment highly sought after by Chinese investors. Based on the most recent valuations provided by the company, Ferrotec Holdings' stakes in these subsidiaries, plus its existing holdings in other listed companies, would exceed its own current listed market capitalisation even after tax. It is likely that the actual valuations achieved by the IPO's would further exceed these levels given the rally in semiconductor stocks, as shown by the Macquarie analyst's estimates below.

Ferrotec Holdings: Market Capitalisation Versus Value of Listed Holdings and IPO Candidates (After Tax)

Source: Ferrotec Holdings IR Material (March 2023)

Across our Japan portfolio we continue to hold high quality companies, with strong international growth and sustainable competitive advantages, that trade on extremely low valuations with significant value to be unlocked.

CURRENCY

RG8 is denominated in Australian Dollars (AUD). Since mid-CY20 currency exposures have been hedged. If net exposure to a particular currency exceeds 5% of the Fund's Net Asset Value (NAV), we will seek to manage the foreign currency risk in respect of that currency by hedging to AUD.

IN CLOSING

We have been pleased with the first full-year of performance under the Regal team, with a FY23 net portfolio return of +8.3% after all fees, with an average net exposure of +64%. Looking ahead we see the outlook for investment returns in Asia as particularly appealing. As we have highlighted in this letter this does not simply emanate from low overall market valuations, or high equity risk-premia, but also due to the value we think will be unlocked across a range of our specific investments in quality growing companies. We remain very optimistic for the strategy and look forward to continuing to keep investors updated with our progress.

We have always viewed the opportunity to manage our investors' capital as a privilege, and we thank investors for their continued support and encouragement.

Once again, we thank you for your investment.

Yours faithfully,

Regal Partners