CI AUSTRALIAN EQUITIES FUND
QUARTERLY REPORT

Cooper Investors Pty Limited AFS Licence Number 221794 ABN 26 100 409 890

DECEMBER 2014

***"A good decision is based on knowledge and not on numbers."* Plato.**

***"Look at the means which a man employs, consider his motives, observe his pleasures. A man simply cannot conceal himself."* Confucius.**

***"Opinion is the medium between knowledge and ignorance."* Plato.**

	**PORTFOLIO	#BENCHMARK	VALUE ADDED
ROLLING 3 MONTH	8.24%	3.11%	5.13%
ROLLING 1 YEAR	14.52%	5.61%	8.91%
ROLLING 3 YEAR	21.95%	15.14%	6.81%
ROLLING 5 YEAR	12.33%	6.76%	5.57%
ROLLING 7 YEAR	6.21%	2.27%	3.94%
ROLLING 10 YEAR	11.72%	7.56%	4.16%
SINCE INCEPTION*	13.52%	8.92%	4.60%
SINCE INCEPTION^	387.74%	190.83%	196.91%

*Annualised
^Cumulative (4 July 2002)
**Before fees and expenses
#S&P ASX 200 Accumulation Index

Market and Portfolio Performance

The Benchmark rose 3.11% over the quarter and 5.61% over the calendar year. The portfolio returned 8.24% and 14.52% over these periods respectively. The Australian dollar continued to fall against the USD (from 87c to 82c) as the likelihood of a cut in interest rates next year began to loom larger. The oil price continued its dramatic fall from over $100 in June to end the quarter at circa $54. Iron ore prices remained weak and the copper price fell from US$3.00 towards US$2.80 per pound, while the natural gas price in the USA fell from $4 to just over $3 today.

The positive contributors to performance included:

1. Recall – takeover offer from Iron Mountain;
2. Caltex – continued strong performance on the back of operational turnaround underway;
3. Amcor – helped by falling currency; and
4. CSL – helped by falling currency.

The worst performers over the quarter included:

1. Oil Search – continued weak oil price;
2. Woolworths – slightly weak first quarter sales and broker anguish over the likelihood of Woolworths facing the same misfortunes as have befallen Tesco in the UK; and
3. QBE – no substantive news.

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The Portfolio

We experienced a second quarter of little significant change to the portfolio.

Stock News

In December 2013 **Brambles (BXB)** divested **Recall (REC)** via a listing on the ASX. Recall is a Document Management Solutions, Data Protection Services and Secure Destruction Services business which assists companies with their information storage needs.

On December 15th, Recall announced that Iron Mountain, the world's largest Document Storage Company, had launched a non-binding, indicative proposal to acquire Recall. The bid values Recall at A$7 per share with consideration being a combination of Iron Mountain shares (82%) and cash (18%). We believe the deal makes a lot of strategic sense with large business overlap and significant cost and revenue synergies potentially available. However, we were disappointed in both the price of the bid and the composition of the consideration.

On our estimates we believe $150m+ in cost benefits can be comfortably realised upon integrating the two businesses with the opportunity for this to increase to north of $200m. These synergies relate to labour, overhead and real estate cost savings. Revenue upside is also likely. These factors combined with the higher Iron Mountain earnings multiple relative to Recall creates significant value for Iron Mountain shareholders under the current proposal.

As a Recall shareholder with a positive view on the company's stand-alone growth prospects we believe any takeover warrants Recall shareholders getting both a fair price for the company's existing growth prospects while also receiving an appropriate share of the significant synergy benefits that could be realised. We do not believe this is reflected in either the current takeover price or as an Australian domiciled shareholder, by the consideration mix. We see a fairer outcome being achieved at a takeover price north of $8 and with a 100% cash consideration option being available.

There was plenty of news in the telecommunications sector over the quarter.

- **Telstra (TLS)** signed revised definitive agreements with NBN Co and the Commonwealth to enable the rollout of the multi-technology mix (MTM) national broadband network. The estimated net present value in the revised agreements is expected to be equivalent to the original agreements (i.e. approx. $11bn post tax NPV as at 30 June 2010). There is also potential for Telstra to provide planning, design, construction and maintenance services to NBN Co in addition to the revised agreements and generate additional profits for Telstra.

- The Government released its policy response to the Vertigan review of the NBN which has implications for **TPG Telecom (TPG)**. The main points of the Government's policy response:

  - Operators of high speed broadband networks will need to be functionally separated from 1 July 2015, i.e. have separate retail and wholesale divisions. TPG will also be required to provide other retail service providers access to their network.

  - Under previous legislation, there was an implicit cross subsidy, i.e. a flat access price for metro and regional areas which would take into account the higher cost to roll out to regional areas. This cross subsidy will now be explicit and providers of high speed networks will need to pay a levy to NBN Co, which will be introduced on 1 January 2017. The levy amount is still to be determined. As a consequence, the return that TPG Telecom generates on this investment will be reduced. TPG management will need to weigh up these costs to determine whether the company should continue to roll out its FTTB network.

- In separate news, Telstra acquired an Asian telecommunications and services provider Pacnet Limited for US$697m. Pacnet is a provider of connectivity, managed services and data centre services to carriers, corporations and governments in Asia. Pacnet will provide Telstra with ownership of submarine cable systems and data centres. The acquisition is aligned to Telstra's strategy of growing in Asia and allows Telstra to better serve its enterprise and wholesale customers who connect with Asia.

Transpacific Industries (TPI) made two announcements of significance over the quarter. The first was to quantify the cost ($20m) of its grounded fleet after one of its trucks was involved in a fatal traffic accident in August this year. This number was broadly as expected. The second and more significant announcement related to the acquisition by TPI of a landfill asset in Melbourne from Boral for a price of $165m (a multiple of 9.3X EBITDA). While not a cheap price at face value, the acquired site at Deer Park was required to replace the Clayton landfill which is due to close in 2016. The Deer Park site is permitted for the next 7-10 years (depending on the fill rate) and at 1100 hectares has the potential to last for another 40 years thereafter. The acquisition multiple is likely to fall dramatically in 2017 as TPI bring across waste being put into Clayton, and also internalize waste currently being collected but placed into third party landfills. We believe the acquisition is strategically sensible and likely to boost profits materially in future years.

Fisher and Paykel Healthcare (FPH) announced its first half result, continuing its recent string of positive numbers. Both the sleep apnea and respiratory sides of its business currently have very strong momentum and are winning market share. The fall in the NZD against the USD also helps in the longer term and on this occasion allowed the company to marginally upgrade its full year profit outlook. Although the stock price has gone up significantly over the last couple of years, we believe there remains a large market opportunity for the company, particularly on the respiratory side of the business and we retain confidence that management can take advantage of this to grow earnings and cash flows substantially from here.

There has been a burst of activity from **National Australia Bank (NAB)** following the appointment of Andrew Thorburn as the CEO. It has started the process of selling out its US business through the sale via initial public offering of a minority interest in Great Western Bank. We expect NAB will complete the sale over the next year.

During December NAB announced the sale of the majority of its remaining UK commercial real estate loans at a price above book value. This sale effectively brings to an end NAB's costly involvement in troubled UK commercial real estate loans and it is a further step along the path of NAB closing or selling legacy positions and refocussing on its core Australian and New Zealand businesses. We expect a number of further announcements over the next year that should strengthen NAB and improve its return on equity and capital position.

International Trips

We travelled to London in November to investigate the UK pension system and changes that are taking place, and to see if developments there have relevance for the Australian market. Our meetings were with regulators, planners, insurers, banks, fund managers and lawyers. We also attended a two day conference titled Rethinking Retirement Options.

Our first observation is that the UK is in the midst of very big changes to its pension system. In March 2014 the Chancellor of the Exchequer announced a package of pension reforms that were surprisingly significant. The major changes are:

- every worker will be enrolled in a defined contribution pension plan (this happened 22 years ago in Australia);
- upon retiring people will have complete choice of what to do with their pension "pot", this means the "pot" will no longer be compulsorily converted into an annuity; and
- Everyone will be entitled to free "guidance" at the point of retirement.

As a consequence of the changes, sales of annuities have fallen sharply. Indeed the share price of some companies that specialise in annuities roughly halved within a few minutes of the Chancellor's announcement (and have not recovered). Fund managers see an opportunity as money that was previously headed into the annuity market may now be directed into managed equity and fixed interest portfolios.

The second major observation is that life expectancy is steadily rising, this means that most people who retire at sixty will not have saved enough to generate a retirement income for more than 25 years. In fact most people rely to some extent on the Government pension, and with the ageing of the population this will lead to an intolerable strain on Government finances in the decades ahead unless the compulsory contributions to pension plans are increased.

With interest rates at multi decade lows and life expectancy increasing, the prospect of converting a pension "pot" at retirement into a low risk fixed interest portfolio or an annuity based on low interest rates is unappealing.

The UK has a well-developed equity release market, this is where people can sell a portion of their house (and continue to live there) and use the proceeds to help fund their retirement. Equity release seems to be a useful product.

Our final observation is that financial advice or guidance has been fraught with problems in the UK. The general view is that annuities have been a "rip off", equity release has had a "troubled" history, products are too complex and people generally do not think it is worth paying for advice upfront even for a one-off financial plan.

The contrast with Australia on some issues is quite stark but in both countries people are grappling with the problem of finding a reasonable solution to funding retirement.

In Australia annuities represent 0.3% of GDP whereas in the UK the annuity market is around 40% of GDP. To be clear the annuity market in Australia is tiny and most of the current annuities are fixed term products that are not too different to term deposits. It is easy to conclude that this discrepancy should provide companies such as Challenger and AMP with a massive market opportunity to sell guaranteed lifetime annuities. The reality however, that they face difficulties in writing large amounts of lifetime annuities at prices that retirees will find attractive given low interest rates and the high capital requirements of these products. As there are very few lifetime annuities currently offered in Australia it appears the economics do not stack up at present.

Another big contrast is that there are virtually no home equity release products offered in Australia. (Bendigo Bank does offer a similar product called Homesafe). The release of capital from housing could be a source of income for retirees and a good opportunity for banks.

Other investment opportunities should arise from the ageing of the population and the requirement for retirement income, some of these are discussed below in this report in the section on the residential aged care sector.

The issues around quality, impartiality, cost and complexity of financial advice appear quite similar in both Australia and the UK. The outcomes are different however because regulators in the UK are much tougher on companies that offer poor advice than the regulators in Australia. However, we note that the trend in Australia is that regulatory penalties and imposts are rising quite sharply. The increasing costs and obligations around financial advice and the provision of investment products will lead to changes in business models in Australia and may lead to some major banks selling at least parts of their wealth management businesses.

We feel that with retirement investment horizons increasing to 20-30 years it is essential that some portion of a retirement financial plan should include an equities component in order to protect the capital balance. To this end we opened the CI Pensions Fund in March 2014. This fund is an equities portfolio that aims for lower volatility than the market and to perform better in negative markets and it is designed to form part of a portfolio that aims to provide sustainable and growing income. The focus for retirees is more about growing the income than growing the asset base reflecting changing circumstances as people retire.

A final point is that one major recommendation from the Financial Services Inquiry is that Australia should enshrine in legislation that the primary objective of the superannuation system should be "to provide income in retirement to substitute or supplement the Age Pension." This recommendation points to a greater emphasis on income in retirement in the future. Until now most emphasis has been on asset accumulation prior to retirement.

The debate on retirement income is at a very early stage in the UK as it is in Australia.

Market Observations

We observe that regulatory issues continue to affect a large swathe of the market, and generally not for the better. Sectors which have recently been or are currently being impacted by regulatory and government affairs include:

1. Banks – the Murray enquiry is likely to lead to increased capital requirements. If overseas trends are followed, leverage ratios may come under closer scrutiny.
2. Pharmaceuticals – the restrictions on the Pharmaceutical Benefits Scheme and generic pricing have made revenue growth very difficult for the Pharmaceutical wholesalers.
3. Utilities - revenue lines are now coming under pressure as lower interest rates reduce the rates of return allowed by regulators.
4. Medibank Private and other health insurers will need ongoing government approval for premium rate rises every year – now that Medibank private is listed we wonder if the Government will be so keen to allow 6-7% rate rises.
5. The Harper Review is looking into competition policy and its final decision may lead to changes which restrict large retailers' activities.
6. To date coal seam extraction in parts of NSW has been stopped by government.
7. The ACCC and government policy play a major role in the telco sector e.g. impact on TPG as per above.
8. Aged care, due to its dependency on government funding, is always hostage to policy change (see comments in this report below).

Over the calendar year new floats raised circa $18.6B, the largest amount for the last 14 years, and twice the amount raised in 2013. Towards the end of the year fatigue set in and a number of floats were repriced (Godfreys, Surfstitch, OohMedia) or abandoned. However the largest float of the year, **Medibank Private (MPL)** listed on the 28th November 2014 for $2.15 (raising $5.6B) in the most highly anticipated IPO since Aurizon was floated in 2010, and attracted significant interest from both Retail and Institutional investors.

Our core investment proposition for MPL was based around the "privatisation dividend" from an increased focus on costs and operating efficiency, as well as the release of management energy as the organisation moves from a government bureaucracy to a more commercially focused listed operator. Management also emphasised the significant opportunity to improve margins via claims cost management, given claims costs represent around 87% of premium revenue. We believe that the industry and regulatory structure is such that to arrest market share declines in recent years, MPL will have to reinvest at least some of their cost savings into lower premium prices.

MPL is a solid business with good prospects for earnings growth. In our opinion, however, this was more than factored into the final institutional IPO price of $2.15, which represented 23 times FY15 forecast pro-forma earnings. We did not believe that bidding $2.15 or more represented a good balance between risk and reward.

The listed Australian residential aged care sector emerged this year with a number of IPOs including Japara Healthcare, Regis Healthcare and Estia Health. We expect further IPOs over the coming 12-18 months reflecting the capital investment flowing into the sector and investor demand for structural growth assets.

The attraction of the **Australian residential aged care sector** is based around the strong demographic tailwinds from an ageing population, the large consolidation opportunity in what is a highly fragmented market, and the pipeline of greenfield and brownfield developments required to meet the burgeoning demand.

In addition, regulatory changes effective from 1 July 2014 mean that operators will be able to charge accommodation bonds for high care places, which typically represent over 80% of places in a facility. This will be very positive for the industry in terms of funding their ongoing operations and improving the economics of their business model.

During the year the regulatory risks for the sector were brought into sharp focus by the Government's announcements around the removal of the Payroll Tax Supplement and the Dementia Supplement. These businesses are highly regulated with around 70% of revenues sourced from Government funding. We think the risks around funding should not be underestimated, particularly as the Government seeks to move to a more user pays system and deals with greater budgetary pressures.

In our opinion, New Zealand retirement operators such as Ryman and Summerset continue to set the benchmark for the sector. Valuations aside, both have a long track record of strong operating performance and have demonstrated an ability to manage both operational and regulatory risks. Importantly, portfolio expansion has been driven organically via greenfield developments and without acquisitions. Organic expansion may mean slower growth but we believe on a risk adjusted basis it is a superior operating model. We note that a number of operators in both Australia and New Zealand have had significant issues following an acquisition led expansion strategy.

Resource (and resource related – mining contractor) companies under-performed as commodity prices continued their downward trend in the quarter. The diversified low cost miners such as BHP and RIO out-performed the small to mid-cap miners where a mix of high cost operating assets and leverage proved disastrous against the backdrop of falling commodity prices. Some relief was provided to the junior iron ore miners by the WA Government in the form of a reduced royalty over a 12 month period. However, it is worth noting that a number of the junior iron ore miners still produce a cash loss at the current spot price.

Both **BHP** and **RIO** held their investor days during the quarter. It is clear they have shifted their focus to reducing costs and maximising their existing asset base following a period of high capex spend. Although both companies should benefit from an increase in production over the next few years, it comes at a time when commodity prices, including iron ore and coal, are trading at multi-year lows. As we noted in our previous quarterly, we are yet to witness any significant iron ore mine closures. Following a period of under-performance, both companies now trade at large discounts to consensus valuation. However, the spot commodity prices are now well below the consensus long-term price assumptions. Lowering the long-term price assumptions would indicate that both BHP and RIO are closer to fair value rather than outright cheap. We believe that it is prudent to use lower long-term price assumptions given that industry cost curves for most commodities are likely to fall further over time.

We have done some analysis with these lower long-term price assumptions in our models for the next two years. As illustrated in the table below, profits for both companies would deteriorate significantly based on these numbers. The progressive dividends on offer are attractive but both companies would struggle to fund this out of free cash flow. To fund this shortfall, management can reduce capex and there is some balance sheet capacity. All of this does not paint a pretty picture, but we need to remind ourselves that mining is cyclical and it will eventually turn. Based on asset multiples, both companies are starting to look attractive.

BHP

	FY14A	**FY15F**	**FY16F**
NPAT	13,447	8,296	7,504
change		*-38.3%*	*-9.6%*
P/E	12.9	15.3	16.8
Div yield #	3.7%	5.1%	5.1%
P/B	2.0	1.5	1.5

RIO

	CY13A	**CY14F**	**CY15F**
NPAT	10,217	7,877	6,249
change		*-22.9%*	*-20.7%*
P/E	11.9	10.9	13.7
Div yield#	2.9%	4.1%	4.1%
P/B	2.3	1.6	1.6

Assumes dividend held constant (121UScps for BHP and 192UScps for RIO)

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