CI AUSTRALIAN EQUITIES FUND
QUARTERLY COMMENTARY REPORT

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

For current performance information please refer to the Monthly Performance Report.

DECEMBER 2015

"Chaos is inherent in all compounded things. Strive on with diligence."   Buddha

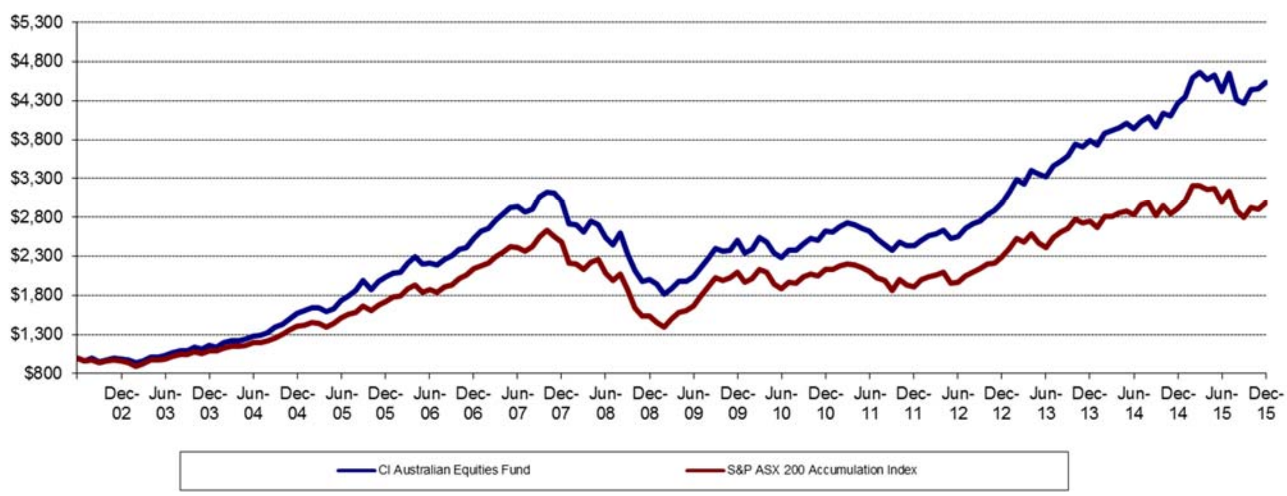
"The policy of being too cautious is the greatest risk of all."   Jawaharlal Nehru

"In order to properly understand the big picture, everyone should fear becoming mentally clouded and obsessed with one small section of truth."   Xun Zi

	**PORTFOLIO	#BENCHMARK	VALUE ADDED
ROLLING 3 MONTH	6.52%	6.48%	0.04%
ROLLING 1 YEAR	7.92%	2.56%	5.36%
ROLLING 3 YEAR	16.69%	9.20%	7.49%
ROLLING 5 YEAR	12.89%	6.97%	5.92%
ROLLING 7 YEAR	13.65%	10.01%	3.64%
ROLLING 10 YEAR	9.50%	5.64%	3.86%
SINCE INCEPTION*	13.10%	8.43%	4.67%
SINCE INCEPTION^	426.36%	198.28%	228.08%

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

CI Australian Equities Fund - Net of Fees
$1000 Invested Since Inception



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Market and Portfolio Performance

The ASX 200 Accumulation Index staged a minor rally over the last quarter to be up by 6.48%. Coming after two consecutive quarters of negative returns, the stronger finish to the year was just enough to lift the total return index for the calendar year into positive territory at 2.56%. Albeit pre-dividends the capitalisation index fell 2.13% for the calendar year, making it the first year the capitalisation index has fallen since 2011.

Positive contributors to portfolio performance over the quarter included Fisher & Paykel Healthcare (strong result) and Caltex (upgraded full year guidance on higher refining margins and good operating performance). On the negative side Sims Metal underperformed the market (industry scrap volumes have deteriorated further) as did Aurizon (lower coal volumes).

It was another tough year for the resources sector in general, and it is the fifth consecutive year that both BHP and RIO have underperformed the broader market. The underperformance has not been without good reason given the substantial fall in commodity prices. Energy stocks also suffered with the oil price sliding to ten year lows, exacerbated by the long anticipated multi-billion dollar equity raisings by both Origin and Santos.

We are probably closer to the end of the downturn as prices are now deep into the cost curves for most commodities (although we continue to be surprised by the fall in costs) and supply continues to adjust to a lower demand environment. Some of the general industry indicators we will be looking for to point to an improvement in the outlook include further supply curtailments, consolidation of small to mid-sized players, opportunistic buyers (e.g. private equity), contractor order books and change in management behaviour.

Late in the quarter the USA Federal Reserve raised its interest rate by 25 bps – a move widely anticipated by markets and without which it is likely the Fed would have lost credibility given its recent posturings on this issue. We do not expect this move in isolation to have much impact on markets in general – the rhetoric over the next few months is likely to be more important in assessing medium and longer term trends. There are mixed views in the market – some are of the view that the Fed will need to reverse course next year as the US economy weakens, others believe this is the first of four similar rate rises over the next twelve months.

While ten year bond yields have generally remained static or risen slightly over the quarter, a large number of government bonds in Europe remain negative. Foremost is Switzerland where rates are negative all the way along the curve to ten years, negative rates are seen out to four-five years in Germany, Netherlands, France, Denmark and Ireland amongst others. In addition the ECB deposit rate is now -0.3% i.e. it charges banks this amount to hold their deposits! This is a situation the world has not seen for a very long time. Given that most valuations are driven off interest rates/bond yields, there is now an opaqueness in one's ability to effectively value other securities.

The Portfolio

During the quarter **Link Administration Holdings (LNK)** listed on the Australian Stock Exchange at $6.37 and a $2.3 billion market capitalisation. Link is the largest provider of fund administration services to Australia's superannuation industry, as well as a leading provider of share registry and shareholder analytics services. We applied for shares as part of the initial public offer as we were attracted to the high quality of the business and the recurring and sticky nature of its revenue. The integration of Superpartners over the next few years could unlock significant value via cost-out, as well as de-risking the investment proposition as project milestones are delivered. Importantly, the CEO and CFO have been at Link since 2002 and have a long track record of acquiring and integrating businesses.

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During the quarter **Transurban Group (TCL)** reached agreement to acquire the AirportLink in Brisbane for $1.87B. In order to maintain it's gearing ratio and to allow some future operating flexibility the company raised $1.025B in equity to help fund the deal. We subscribed to the issue. The AirportLink is a logical extension of Transurban's Queensland road network and will allow the company to drive efficiencies into the acquired business via integration into its current operations in Brisbane. Later in the quarter Transurban announced that it was in exclusive negotiations with the Victorian government on the $5.5B Western Distributor project. This would further extend the list of projects in which Transurban is engaged – and perhaps most importantly may result in an extension of its Citilink concession time.

Stock News

National Australia Bank (NAB) finalized the sale of 80% of MLC to Nippon Life, and confirmed the spin off of Clydesdale Bank in early 2016. Both actions continue management's efforts to clean up the company's balance sheet and revert to its traditional strengths in Australia. These asset divestments, coming after the resolution of the commercial real estate problems in the UK, will lift the bank's ROE towards the mid teens. From here the heavy lifting needs to be done by the core operations of the bank, in particular its business banking division which is slowly recovering from having lost its way over the last few years.

After raising capital for regulatory reasons, the four major banks all raised their interest rates by approximately 20bps in October, justifying this course of action as the result of having to hold more capital to cover loan losses. Perhaps the most interesting aspect of the industry's move was the fact that there was so little reaction from government – normally one would expect a round of "bank bashing" but on this occasion there was almost no negative sentiment forcefully expressed. Although we remain underweight the sector as discussed in previous quarterlies, we are cognisant of the powerful position of the banks in Australia and their importance to the economy.

Fisher and Paykel Healthcare (FPH) announced its record half year net profit during the quarter. Both parts of the business, sleep apnea and respiratory, continue to grow at double digit rates and grow market share. Combined with expanding margins this has made for very healthy profit growth of late. There remains a long runway of opportunity in its respiratory business as it rolls out its products into the oxygen, invasive ventilation and surgical arenas. To date its innovation in masks has helped the company keep growing share in sleep apnea – this will become harder to achieve as **Resmed Inc (RMD)** in particular has now adjusted to the increased level of competition. Fisher and Paykel Healthcare continue to target medium/long term growth in the mid teens percentages overall. Targetting this level of growth is a big, but achievable, task. We note this will need to be undertaken with a new CEO at the helm as Michael Daniell has resigned after 30+ years with the company. Mr Daniell will be joining the Board as a non-executive director – while we normally regard such moves with suspicion, on this occasion, given his long tenure with the company and industry knowledge, we are prepared to support the move.

As usual, **CSL Limited (CSL)** held its Research and Development day in early December attended by market and banking industry participants. For the most part it was a positive update – from outside the company it is generally difficult to look deeply into or value the project pipeline, but over the years it has added a lot of value to the company. The new recombinant hemophiliac products it has been working on for some years are now not far from coming onto the market, and a number of other interesting new products (cancer, heart attack) are working their way through the clinical trial phases. Although we would not ascribe a lot of value to the earlier stage projects there are one or two that could be very large if successful.

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After much press speculation **Tabcorp Holdings Ltd (TAH)** and Tatts Group Ltd (TTS) both released statements to the effect that merger discussions had been halted as the companies were unable to reach mutually acceptable merger terms. This is a very disappointing outcome – we believe a merger would be beneficial for both companies and would yield potentially large value enhancing synergies both with regard to costs and also national branding and pricing. We hope arrogance and hubris and a focus on short term share price moves on the part of management and the board of directors at both companies has not got in the way of a sensible deal, and that we will see the resumption of talks.

Shortly after this news, Tabcorp announced that it has agreed to partner with News UK in the formation of a new online wagering and gaming business in the UK and Irish markets. We see the low capital and opex approach to this market as a positive given we believe it will be an incredibly challenging task. However, we are concerned that it could distract management from the main game, being the Australian wagering market, given the company has a lot on its plate at home in growing their online business while sustaining retail volumes. We are not sure what Tabcorp will bring to a UK market that is closer to maturity than Australia, and has a number of established and highly competent operators in the online space, and again we hope arrogance and hubris has not got to the Board and management.

Interestingly, regulatory issues played a role in delaying both the two mergers needing regulatory approval within our portfolio stocks. **Recall Holdings (REC)** delayed until March 2016 the meeting at which its shareholders are due to vote on the merger with Iron Mountain Inc (IRM.US) to allow regulatory approvals to be finalized. The NZ Commerce Commission ruling on the **Z Energy Limited (ZNZ)** acquisition of Caltex Australia Ltd (CTX) in New Zealand was deferred to April 2016. It would appear regulatory bodies around the globe are unable to make timely decisions. There are $1.4TR of deals outstanding in North America, and 9 of the top 20 deals are trading at a discount of over 10% suggesting a level of uncertainty as to whether the deals will get through.

Market Observations

Healthcare

A number of regulatory reviews for the healthcare system have been announced by the Government including the Medical Benefit Schedule (MBS), Private Health Insurance (PHI), chronic and complex care, and the Reform of the Federation White Paper. Finally, the Government is also working on a roadmap for the next wave of aged care reform via the Aged Care Sector Committee.

Federal Health Minister Sussan Ley's speech to the National Press Club in October identified that key objectives for these reviews are to remove inefficiencies and to reset healthcare policy via structural reform. Whilst it was made clear that these reviews are not about absolute cost cuts, our read-through is that healthcare providers will not be immune to the budgetary constraints imposed by government.

Sectors that will likely be impacted by these reforms include private health insurance, pathology, diagnostic imaging, medical centres, hospitals and aged care, and we expect funding pressures to be an ongoing theme for these businesses. The risks associated with companies that rely heavily on government funding for their income was highlighted in the recent Mid-Year Economic and Fiscal Outlook (MYEFO) which announced cuts to pathology bulk bill incentives, reduced incentives for diagnostic imaging and caps on aged care funding. This will impact companies such as Sonic Healthcare Limited (SHL), Primary Health Care (PRY), and **Regis Healthcare (REG)**.

There are also risks for the private health insurance industry based on recent commentary from the Government considering the abolition of the 30% rebate on ancillary cover, an increased focus on the high returns providers are earning on effectively a mandated service, and a heighted political sensitivity to affordability issues around premium prices which are growing at more than twice the rate of inflation. These issues continue to make us cautious around the outlook for Medibank Private (MPL).

Any potential negative changes to the private health insurance sector would in all likelihood flow on to the private hospital sector. While we expect negotiations between the hospitals and the insurers to remain “robust” (as we have observed recently between Medibank and Healthscope Limited (HSO)), rather than the headline debate around hospital price rises relative to health insurance premium increases we see key areas for discussion between hospitals and insurers as relating more to the quality of and responsibility for procedural outcomes. In this context those large hospital groups such as **Ramsay Health Care Ltd (RHC)** and Healthscope which are able to secure the highest quality staff are best positioned. Another issue we are monitoring is any government initiatives around pricing of prosthetics which insurance groups are claiming is far too high. While there are many different views as to who is making what money out of prosthetics, we observe comments from both Ramsay and Healthscope that they do not make a material amount from prosthetics rather they simply pass their costs through. Of Ramsay’s $6.6bn in FY15 operating costs we estimate $0.6bn related to prosthetics while in the case of Healthscope’s $1.8bn in operating costs, approximately $0.3bn was attributable to prosthetics.

<u>Oil and Gas</u>

During December Woodside Petroleum (WPL) announced that they were no longer pursuing their proposed merger with **Oil Search (OSH)**. The OSH share price promptly retraced towards its previous lows, reflective of the weak oil price environment. It would appear as that WPL could not reach agreement with key stake holders, particularly the Papua New Guinea government, on the appropriate price and/or cash consideration component of the transaction. The attempt by WPL to acquire OSH confirms that OSH has some high quality assets.

We recently participated in a site tour of OSH’s assets in PNG, which included the PNG LNG facility near Port Moresby, the Hides gas conditioning plant and the Elk/Antelope discovery; as well as presentations from a number of key executives from both OSH and their JV partners Exxon Mobil Corp (XOM) and Total S.A. (FP.FR). A key take-away from the site visit was the strength of ExxonMobil as a partner and the respect that they have for OSH as a contributor to the PNG operations. Exxon have deep global experience as an operator and developer in the oil and gas industry and they bring a rigour and military like execution to their operations. This however can at times be to the detriment of local sensibilities. One of the strengths that OSH bring to the venture, given their long experience in PNG, is providing a deep understanding of the specific local complexities associated with operating in PNG.

The production facilities visited have been built to a high standard and significant operating latency exits in the LNG facility, the upstream processor, and connecting pipelines. They appear to have been built with expansion in mind, as there is ample land and inbuilt capacity to enable expansion with significantly reduced capital expenditure requirements. This is encouraging for the economics of the proposed addition of another processing train to the current two train LNG facility.

At the time of our visit Exxon were also running a high rate production test at the facility and detailed some of the bottlenecks that they were working on resolving to increase production from the existing facility. The joint venture has already indicated that they will be producing at 7.7mt p.a. of LNG, more than 10% above the name plate capacity of the facility. Sustainable output at or above 8mtpa appears to be what they are striving to achieve. In discussions with the local management Exxon come across as a careful and disciplined operator.

The development of the Elk/Antelope discovery as the “Papua LNG” project is now being led by French company Total. This project is in the process of defining the reserves available before moving on to project engineering. The amount of gas reserves proved up will determine whether or not this development is a one or two train LNG project.

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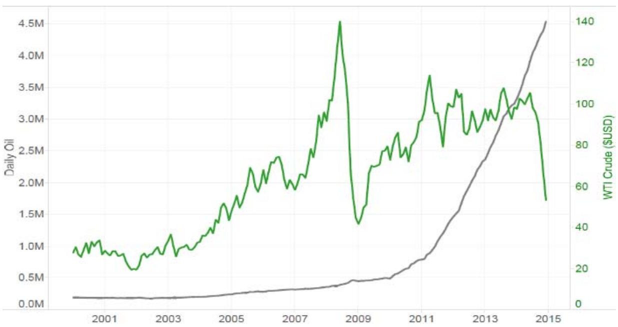
The current industry backdrop remains challenging for oil and gas companies. Oil prices have fallen more than 30% over the last 12 months on top of the 45% decline seen in 2014. This significant weakness has been brought about by a number of factors, including:

- The significant increase in non-OPEC supply; primarily the rise of US shale as a significant supplier into the market (see figure 1 below).
- The decision by Saudi Arabia to no longer act as the swing supplier and increasing supply, in what appears to be an effort to force out higher cost suppliers.
- Slower demand growth in both the developed and emerging world economies.

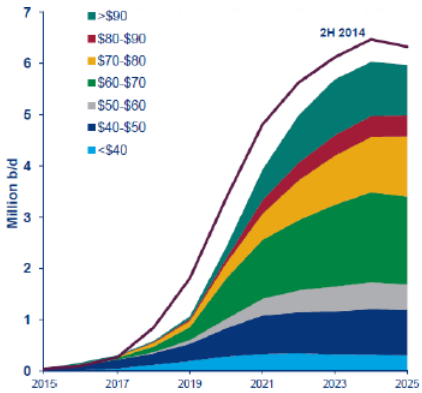
Figure 1: The rise of US shale



Source: Macquarie Capital (USA), IHS, Bloomberg

Oil prices now sit below US$40 a barrel making the development of many new oil and gas projects difficult. At current oil prices many new projects will struggle to make an economic return (see figure 2), while the effect of lower revenues and cash flow in the industry will constrict the availability of capital to develop new projects.

Figure 2: Pre-sanction projects by breakeven band



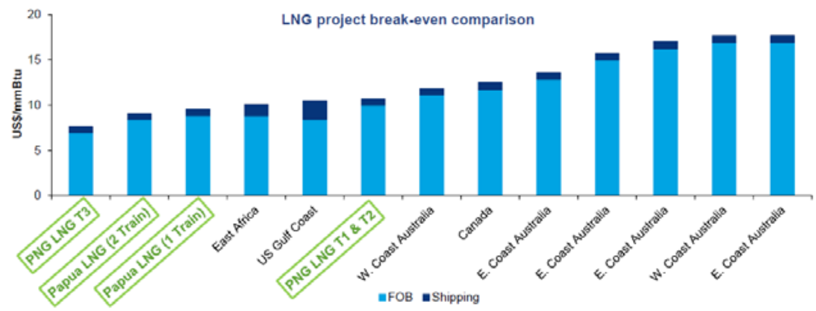
Source: Wood Mackenzie 15% IRR, Deutsche Bank

With a limited number of new projects being sanctioned and the natural decline curve of oil projects in current production, supply and demand will gradually move back into balance over the next few years. This decline curve is amplified for US shale oil, which experiences production declines of 45-50% in year one, meaning that significant capital expenditure is required to maintain production rates. Oil prices will eventually need to move back to a level that will incentivise companies to invest in new projects. Given the cost base of potential oil developments, in particular US shale, this price currently appears to be in the US$50-60 per barrel range.

The outlook for major LNG projects also looks challenged, with high up front capital requirements combined with the LNG industry heading into an unprecedented period of excess supply, as a large number of LNG projects in Australia and the US are either nearing completion or in ramp-up phase. While much of the LNG from these projects has been sold under long term contracts, a significant amount has been sold to parties who are not likely to be the natural end consumer of the product. With supply exceeding demand over the next few years, this excess LNG supply is likely to put significant pressure on prices in the spot market, making it even more difficult to secure long-term contracts with buyers at prices that will support the development of major new LNG projects.

It is in a weak industry environment that poorly positioned companies are exposed. Conversely, companies that have a strong balance sheet and cash flow, and projects that sit low on the cost curve have the most attractive characteristics from a VoF perspective. The balance sheet and cash flow enables these companies to continue to progress projects through periods of low oil prices while potential new projects at the low end of the cost curve provide significant value latency. These companies are best positioned to come out of the difficult industry environment in a stronger position. OSH has many of these attributes, which makes it stand out in a sector where companies are either under significant capital constraints and/or have limited growth options. Although both the PNG LNG Train 3 and Papua LNG projects have some way to go before final investment decisions are made, they rank as two of the most attractive LNG developments globally (see figure 3 below) and OSH has world class joint venture partners in ExxonMobil and Total.

Figure 3: LNG cost curve



Source: Oil Search, Wood McKenzie, full-life breakeven, 12 % discount rate, shipping to Japan

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Coal

The last 12 months has seen a fall in both thermal and coking coal prices. The fall in the Australian dollar along with general cost reduction and improved productivity has helped Australian producers' relative competitive position. However, the spot price for both thermal and coking coal is now at a level where it is deep into the cost curve.

In the case of thermal coal, seaborne trade is expected to decline this calendar year which will mark the second consecutive year of decline. The seaborne trade has grown significantly over the past two decades which has seen Indonesia emerge as the biggest exporter with China becoming the largest importer. The weakness over recent years has predominantly been driven by China as it transitions to a more services led economy which is less energy intensive. In addition, China has started to impose stricter quality controls on imports which has had a significant impact on Indonesian exports due to its lower calorific thermal coal. Indonesian exports look to have peaked in 2014 at ~420mt and they are expected to decline to ~360mt this year. Although production from Australia is expected to remain broadly flat this calendar year (see chart 1 below), a large proportion of producers are now loss making on a cash basis (see chart 2 below). The barriers to exit are not insignificant with take-or-pay contracts and mine closure and rehabilitation costs being the main considerations. The recent announcement by Glencore to reduce headcount and mining at Collinsville if conditions do not improve indicate the severity of the market.

On a more positive note, the build out of super and ultra super-critical plants will support demand for high quality thermal coal with high calorific content, low ash and sulphur. Australia should be a beneficiary of this with key export markets being Japan, South Korea and Taiwan representing ~65% of total exports.

Chart 1: Australia thermal coal exports

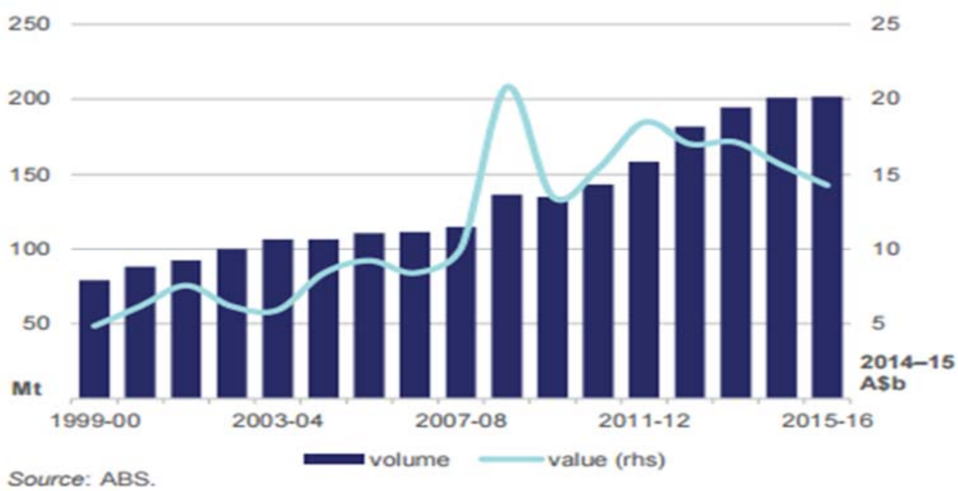
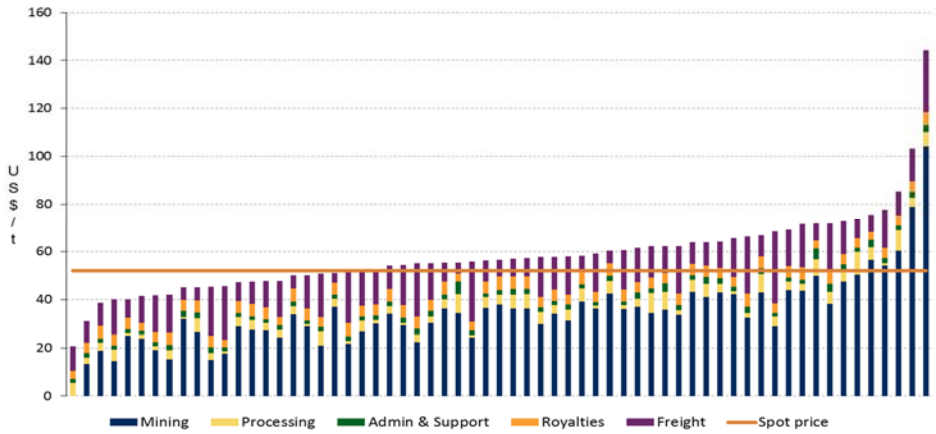


Chart 2: Australia thermal coal cost curve



Seaborne demand for coking coal is also expected to decline this calendar year. China's consumption year to date has fallen due to a weak steel sector and increased consumption of domestically sourced coal. US producers have been hit the hardest as there is no currency benefit. We have seen some decline in production from the US but there still remains a meaningful amount of sticky loss making production due to US bankruptcy laws. Australia dominates the seaborne market with ~60% market share. Australian producers predominantly reside at the lower end of the cost curve (Chart 4). Until the market rebalances, the outlook looks weak.

Chart 3: Australia metallurgical coal exports

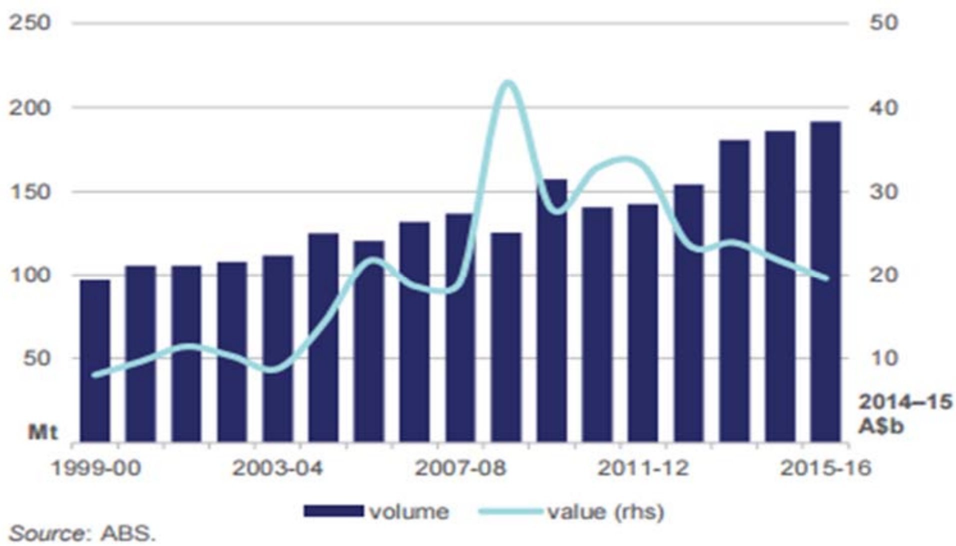


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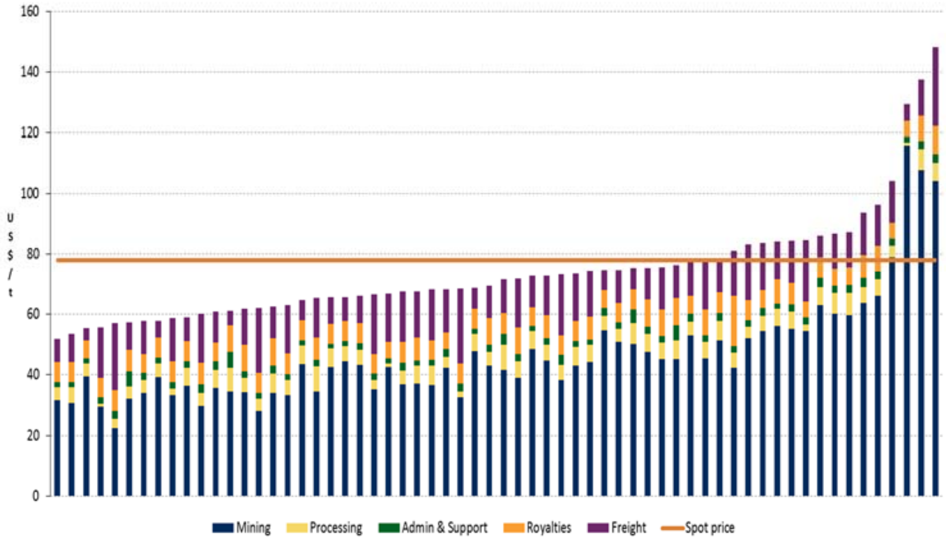
Chart 4: Australia metallurgical coal cost curve



As we witnessed in its market update in late December, and despite the company's take or pay contracts, **Aurizon (AZJ)** as a service provider to coal companies is not immune to the weak macro environment. While volume changes can have a material impact on the company's earnings, changes in contract pricing can also have a large impact on profits. Although we were very pleased the company has elected not to proceed with ongoing work on the West Pilbara project we were disappointed with its negative trading update. We understand the challenging environment AZJ operate in, however look to the management and board to actively manage their take or pay contracts, operational initiatives and capital management opportunities.

Trip Notes

During the quarter we visited the hospital industry in the UK and France where Ramsay (RHC) has large exposures. These markets are different to that existing in Australia in that RHC depends to a far greater degree on government payments and thus the rates set by government in the UK and France, albeit the industry operates slightly differently in each region. The company has to date done well in both markets considering the negative trends in rates paid by the government over recent years. And despite a tough rate environment in both countries, volume growth, mix/acuity upgrades, brownfield and greenfield expansion, scale efficiencies and cost out programs should enable RHC to grow earnings in both jurisdictions over the next few years.

In France it looks likely that the rate will drop at 0.5 - 1% p.a. A change in government would probably be helpful in arresting this trend and achieving a more balanced approach between the private and public sectors. Having said that, volumes are growing at 2%+ from population increase (800k births p.a.), immigration and ageing demographics. In public hospitals staff are 70% of the cost base compared to 50% in the private system and RHC should be able to bring increased cost focus to the hospitals it has acquired. The market remains in consolidation mode as too many hospitals have been built in France – we believe up to 500 hospitals remain for sale. Industry returns are generally low due to this overcapacity. RHC now have 115 hospitals in France – as they restructure this number will come down, increased specialisation will occur and utilisation will rise. It appears synergies from the recent GDS merger will well exceed early estimates.

In the UK RHC has a very good reputation amongst its peers. Since entering the market some years ago it has consistently grown volumes (in the main via NHS/public patient growth) and profits. Having had a period of stabilisation, NHS waiting lists are rising again now. There are also small signs of growth in self pay patient volumes given the length of wait required on the NHS. Interestingly, the private operators are seeing more doctors willing to work in private hospitals (generational and lifestyle issues), and more doctors willing to work exclusively across one operator's sites. The NHS trusts are under huge strain – 66% are in deficit. This means they will be looking for efficiencies and thus over time will look to utilise the private system more than in the past.

We visited China again in late November. We wrote extensively about China in our September quarterly, and our findings on this latest trip only served to confirm what we learnt earlier in the year. The boom in China's economic growth, and demand for commodities, was driven off fixed capital investment, export growth fuelled by abundant cheap labour, and the urbanization of hundreds of millions of Chinese being brought into the so called "middle class". A lot of this phenomenon was centrally debt funded with the result that government debt to GDP in China has jumped to circa 240%. The capacity and desire of the Chinese government to continue further down this road is questionable. Thus we are seeing a transition to a more consumption and services based economy. In the USA consumption accounts for approximately 70% of GDP, in China it is currently 36% - so they have a long way to go and it will not happen quickly. The slowing in demand in China has meant there remains overcapacity in many heavy industries – aluminium, coal, steel – which is leading to retrenchments in these industries. Indeed the chairman of one of China's biggest private steel companies was quoted as saying that China's steel production should be in the range of 600-700m tons rather than the current 830m tons. As this unwind occurs the outlook for commodity prices is likely to remain difficult.