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 2017

"I know a lot of you are wondering, why did the Murdoch's come to such a momentous decision (to sell Fox)? Are we retreating? Absolutely not. We are pivoting at a pivotal moment." Rupert Murdoch

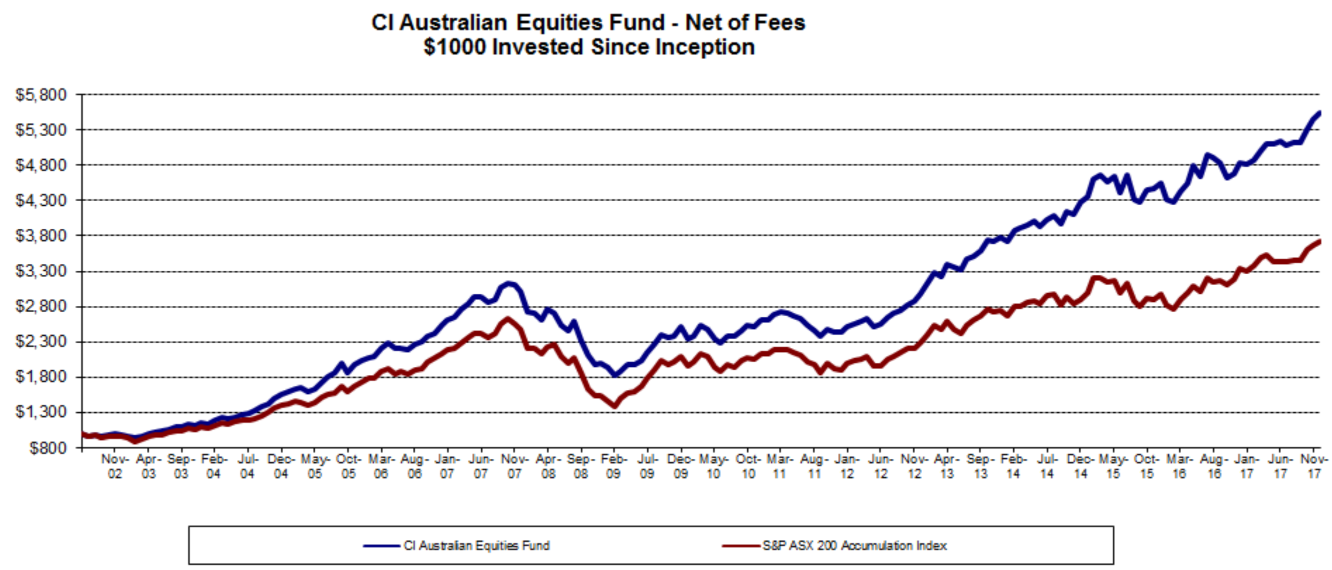
"…the principal contradiction facing Chinese society has evolved. What we now face is the contradiction between unbalanced and inadequate development and the people's ever-growing needs for a better life." Xi Jinping

"It is always wise to look ahead, but difficult to look further than you can see." Winston Churchill

"Bull markets are born on pessimism, grow on scepticism, mature on optimism and die of euphoria." John Templeton

	**PORTFOLIO	#BENCHMARK	VALUE ADDED
ROLLING 3 MONTH	8.41%	7.64%	0.77%
ROLLING 1 YEAR	15.58%	11.80%	3.78%
ROLLING 3 YEAR	10.36%	8.63%	1.73%
ROLLING 5 YEAR	14.62%	10.23%	4.39%
ROLLING 7 YEAR	12.52%	8.33%	4.19%
ROLLING 10 YEAR	7.44%	4.14%	3.30%
SINCE INCEPTION*	12.90%	8.86%	4.04%
SINCE INCEPTION^	555.58%	272.80%	282.78%

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



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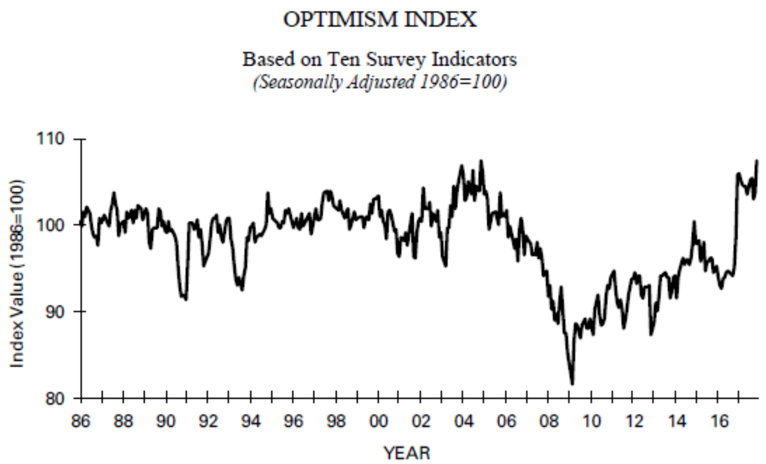
Market and Portfolio Performance

The ASX200 Accumulation Index performed strongly in the December quarter, rising 7.6%, mirroring the performance in US and Asian markets.

A key driver behind the strength of the US equity market was the passing of the tax reform bill in December, one of the most significant changes to the US tax code in 30 years. The changes involve lowering the corporate tax rate (35% to 21%), increasing the deductibility of capital spend, and putting some limitations on the deductibility of interest. The net result is an expected ~$1.5 trillion tax cut and an ~10% increase to corporate earnings per share (domestic focused businesses to benefit the most). Although a portion of the direct benefit to corporate earnings will be competed away over time, there are also second and third order impacts that are harder to read. However, simplistically, the tax cuts are likely to be stimulatory for the US economy, with flow on effects to the currency and interest rate markets.

This is on top of an economy that has been steadily improving. This was evident to us in our recent trips to the US and we have seen an increased confidence to invest by the companies we have visited. This is also being seen in the unlisted sector, as illustrated by the most recent NFIB survey of small businesses (November 2017) with their Small Business Optimism Index at the second highest level of its 44 year history (see chart below).



Source: NFIB Research Centre, "NFIB Small Business Economic Trends", November 2017

The other notable global event during the quarter was the 19th National Congress of the Communist Party of China. We were travelling through China at the time (a summary of our findings can be found below in this report). Apart from a noticeably heightened level of security and closure of various industrial activities around Beijing to ensure the skies remained clear of pollution for the Congress, there was also a sense of this Congress being a defining event. The 19th National Congress, with the raft of new leaders put in place and the policies that they will pursue to address the challenges and opportunities faced by China, will be critical to the social, political and economic development of China over the next few decades.

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One could argue that it is business as usual with President Xi having consolidated his powerbase and the party leadership in Beijing exerting more control over the regions. However, what we have seen over the last few years has not been business as usual for China, with policy moves to deal with overcapacity, excess leverage, and environmental issues along with a recognition of the need to balance economic development with social development. All of these issues were addressed at length in President Xi's three and a half hour speech, highlighting the Communist Party's intent to tightly manage the country's transition to a more balanced economy. The ramifications of this for Australian investors are difficult to overestimate, with a stable and prosperous China clearly positive for Australian equities in general, and resource related companies in particular. Current observable developments support a more optimistic view on the outlook for China. As is always the case with China, policy development and implementation will need to be monitored closely, as a successful transition, without dislocations, is not only not guaranteed but will be challenging to achieve.

The other interesting news during the quarter were the decisions by two of Australia's most successful businessman – Frank Lowy and Rupert Murdoch – to sell parts of their business empires (Westfield to Unibail-Rodamco and Fox to Disney). It's likely there are multiple reasons behind these decisions. However, they do come at a time when long-term "structural" concerns, such as the threat of Amazon/online to retail shopping malls, and the threat of Netflix and others to the traditional cable/media model, are rising.

While they don't always get it right, insider selling is also highly suggestive of where value lies. Although fundamental metrics of value can be justified with present day nuance (e.g. interest rates are low therefore multiples are higher) behavioural signals are perhaps more telling, with the fear of missing out increasingly observable in today's financial markets (bitcoin being the most obvious recent example). Therefore, while the Australian equities market performance over the 2017 calendar year was pleasing (12% total return), we remain ever vigilant to the build-up of risks in financial markets.

The portfolio slightly outperformed the index during the December quarter 0.77%.

Key contributions to portfolio performance during the 3 month period included **Bluescope Steel** (high steel prices and positive earnings update), **News Corporation** (positive first quarter profit result), and **Boral** (strong trading update at AGM and sentiment from US tax bill).

Portfolio stocks that performed poorly during the quarter include **Fletcher Building** (construction business continues to struggle), **Aurizon** (lower than expected draft decision for their regulated asset returns), and **Amcor** (challenging first quarter operating environment).

The Portfolio

The continued strength in equity markets, with low volatility, low interest rates and low inflation, paints a seemingly benign picture. But, as we discussed last quarter, with it being 10 years since the last major correction we are conscious of the gradual build-up of risks in financial markets. The best protection against these risks is to remain focused on our VoF process which has proven successful through various cycles. As such we continue to be cautious of companies that that have been beneficiaries of the "financialisation" of the global economy, which has underpinned growth in recent decades, and have high levels of debt. On the other side, we have a preference for real or hard assets and companies backed by high levels of cash.

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During the quarter **Cleanaway (CWY)** launched a takeover bid for Tox Solutions, the full cost of which is approximately $830m, and will be funded by an equity raising of $540m and debt of $290m. Given that CWY itself had an enterprise value of circa $2.65B immediately prior to the bid being made public, it is not an insignificant transaction for the company. CWY is paying a post synergy multiple of 7.1x EBITDA and will make a return on investment of approximately 10.5%. As might be imagined in the current low interest rate environment the acquisition is highly earnings per share accretive. Although we anticipate CWY management will, over a period of more than the two years estimated to achieve the stated synergies, improve the TOX business and thus ultimately earn a return greater than 10.5%, this outcome will not be easy. In the early stages the published synergies of $35m should be readily achievable.

Strategically the acquisition makes sense for CWY, enhancing the company's position in both its solids and liquids businesses, as well as bringing with it the leading medical waste business in Australia. While the infrastructure acquired will both assist CWY in filling out the gaps in its network more quickly than if the company had done so organically, and (hopefully) avoid the spectre of overcapacity in the industry were CWY to build such infrastructure itself, the medical waste business is perhaps the most interesting part of the deal. This is a new business for CWY. It should grow at a rate a little faster than the general waste business, it is well entrenched in the health system, and it has the benefit of operating in a regulated environment.

This is CEO Vik Bansal's first major step since his appointment nearly three years ago. To date he and CWY management have achieved success in integrating previously poorly handled acquisitions, cutting cost and capex, and more latterly winning new contract revenue. Two related risks around the TOX acquisition are firstly the risk of distraction in completing the turnaround of the CWY business itself, and secondly the level of resourcing with CWY to manage the integration of TOX. To cater for these risks we believe CWY will sensibly establish three teams - one team to manage the current CWY businesses, one to manage the TOX businesses, and one team independent of the other two to oversee the integration.

This is the first serious move towards consolidation in an industry where further such action is both possible and likely over time. We believe CWY can play an ongoing role in this regard, but management will first need to prove itself with the purchase and integration of TOX.

In December **Transurban (TCL)** announced it had reach contractual close with the Victorian State Government to build, toll and operate the West Gate Tunnel Project (WGTP) until 2045. TCL also announced a $1.9 billion entitlement offer (3 for 37 at $11.40 per share) to help fund their $4 billion share of the WGTP. Construction on the WGTP has commenced and is due to complete in 2022, equating to a concession life of 23 years. We understand that political risk has been addressed by the Government committing to reimburse TCL (including an agreed project return) if the required parliamentary consents are not achieved.

As part of the deal the Citylink concession was extended by 10 years which aligns with expiry of the WGTP. We were surprised by the 4.25% p.a. fixed toll escalation agreed on Citylink and the WGTP for 10 years and 7 years respectively. This replaces the current CPI toll escalation and in a low inflation environment is a significant value driver for TCL. While this comes with some political risk around cost of living pressures, we suspect this pricing concession in part reflects compensation for the negotiated relinquishment of the Material Adverse Event clause associated with new road developments around Citylink. We took up the entitlement offer because it is a good deal for TCL shareholders and is yet another example of strong capital allocation discipline by management.

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After writing at length in our last quarterly report regarding the elevated level of government and regulatory intervention occurring in Australia, this became a reality for **Aurizon (AZJ)** following the draft decision released by the regulator (QCA) in late December. The regulatory revenue in AZJ's below rail network business over the next 4 year period was well below AZJ's proposal and our expectations. Underpinning this outcome, the QCA has assumed what we believe to be an aggressively low cost of capital and low operating and maintenance cost recovery despite the QCA forecasting coal volumes to grow over the period. The draft weighted average cost of capital outcome of 5.43% is lower than recent regulatory decisions on both comparable and lower risk assets (Hunter Valley Coal Network and SEQWater).

One wonders how many companies, in a regulated environment or otherwise, would invest for a sub 5.5% return even in the current low interest rate and low inflation environment. There is currently a consultation period before a final decision is made around mid-2018. This decision is disappointing on a number of fronts and in the short term it potentially offsets some of the improvement in the industry outlook around coal volumes and further productivity initiatives.

Fletcher Building (FBU) was sold out of the portfolio during the quarter. The construction division suffered significant losses due to mismanagement of a number of projects which resulted in multiple downgrades and inevitably a change in CEO. This has been particularly disappointing given the rest of the business has been performing well, benefitting from cyclical tail winds in the New Zealand building cycle. Given the NZ building cycle is likely at its peak and the significant uncertainty remaining around the construction provisioning, we did not have the conviction to retain this underperforming stock in the portfolio.

Trip Notes

In October, we travelled to the UK as part of our company visitation program, which included meetings around **Clydesdale Bank (CYB)**. We came away from our trip with reinforced confidence in our investment proposition for CYB as a low-risk turnaround, a key part of which is backing a high quality management team that continues to meet or exceed targeted milestones. As a general comment, while the UK economy remains stable we remain cognisant of macroeconomic risk given the companies we met with were more concerned about Brexit and dysfunctional politics than 6 and 12 months ago.

In terms of value latencies, the cost-out story remains attractive and our sense is that there is more to do beyond the current 2019 targets to get the cost base back in-line with peers. The advanced accreditation (IRB) process remains on track for the mortgage portfolio by October 2018 which we conservatively estimate will release at least £550m of capital. CYB is also well positioned to benefit from the 'Williams & Glynn' program that the European Union is making RBS fund in order to increase competition in the UK SME sector. This could be substantial for both revenue and costs, as well as potentially fast-tracking CYB's growth plans in SME.

Whilst in the UK we also conducted visits around **Link Group (LNK)**, specifically relating to their recent acquisition of Capita Asset Services (CAS). By way of background, Link acquired CAS from Capital plc in the UK, whose strategy has been a roll-up of various outsourcing businesses over the last 20 years. As can happen, numerous acquisitions were not properly integrated and significant debt was taken on which, combined with two recent profit downgrades, resulted in Capita plc having to sell assets to reduce debt. CAS was considered non-core by Capital plc and that it could better fulfil its potential under more focused ownership.

The acquisition strikes us as a classic corporate carve-out as CAS management had been frustrated by a lack of support and capital from the head office. New ownership, together with investment in the business, could lead to a release of management focus and energy. There is also a significant opportunity for CAS to lift efficiencies after years of underinvestment, although this will take time to realise. Our meetings highlighted that CAS was considered the best business within Capital plc – high quality, solid growth, cash generative, with well-regarded and long-tenured management. While LNK paid a full price for CAS, the acquisition is consistent with strategy, although a couple of new business lines and geographies does increase complexity and risk. In summary, we back management to execute on this transaction noting their track record of acquisition integration.

During the quarter we travelled to the U.S. looking at construction materials and building products, which have become much more significant to **Boral (BLD)** since its acquisition of Headwaters. The outlook for the U.S. economy remains positive and the tax cuts proposed by Trump could provider further stimulus, which provides a good backdrop for these sectors. We remain somewhat more sanguine about tailwinds from infrastructure spending given there has been a lot of talk about it but to-date little evidence it is happening.

Consistent with our trip in March, the housing market is continuing its gradual recovery, particularly in the South, where housing starts and permits are at 10 year highs. Industry feedback was that as a result building product prices are generally increasing in the mid-single digit range, which is a good sign. Encouragingly for BLD, the fly ash business is expected to experience strong growth given its ongoing and increasing use as a partial replacement for cement in producing concrete. This demand is underpinned by the competitive cost position of fly ash relative to cement. Overall our trip reconfirmed the positive industry and operating trends in the U.S. for BLD.

While in the USA we were able to visit **Newscorp (NWS)** management. We have held a position in NWS for more than a year now, and continue to do so today, based on the continuing premise that the stock had a number of areas in which value latency was readily observable. It has a large exposure to one of the leading online real estate companies in the world in realestate.com (REA) and has a not insubstantial net cash position on the balance sheet.

Although some way from stemming the bleeding in traditional print media advertising, management has taken a number of steps to offset this falling revenue stream, including driving the digital subscription base (which continues to grow nicely) and vigorously cutting costs. We believe management are also endeavouring to bring Facebook and Google to the table for discussions around content and the use and delivery thereof, in an environment where increased regulatory scrutiny of these two leading online generators of advertising dollars appears inevitable. In the long term NWS is the owner of several premium mastheads (The Times, Wall Street Journal, The Australian) which should be data rich and enable valuable audience understanding, and are more conducive to the subscription model than tabloids, thus it is well positioned. In the short term the ongoing reduction in print advertising looks set to continue.

The proposed merger of Fox Sports and Foxtel should over time unlock value for NWS (who are swapping 100% ownership of Fox Sports and 50% ownership of Foxtel for 65% ownership of the combined entity) in that it should enable more focused and bureaucracy free management of the business with greater and speedier decision making ability than in a business with two owners with at times unaligned aims. In addition there should be cost savings/synergies arising from the merger. Ultimately we would expect to see at least a part of the business listed, and a more competitive online offering established.

In digital real estate, REA is continuing to grow through product innovation, notwithstanding the fully penetrated nature of the Australian market. In the USA, NWS owns Realtor.com, the number 2 player behind Zillow. Realtor is growing its revenue at double digit pace and has just turned profitable. The market there (albeit structured very differently to what we are used to in Australia) is potentially very large and we believe there is room for more than just one player. NWS will need to choose between investing for growth on the one hand, and lifting margins and profit on the other. We believe they will take the former course and look to grow Realtor's market position for the next few years while maintaining profitability.

We also visited China in October, spending time in Beijing, Tangshan, Jinan, Wuxi and Shanghai. Similarly to our trip in April, the focus was on steel, iron ore, aluminium, mineral sands and the respective downstream customers. Policy decisions have always been key in China, but we came away with the sense that it is becoming even more important, especially in the sectors that we are exposed to in our portfolio. Reforms in heavy industries are likely to continue to take place with the intent to reduce the excess capacity in the market, reduce pollution levels, improve profitability and reduce the high debt levels in SOEs. The supply side reform implemented over the last few years, in industries including coal, steel, aluminium, cement and chemicals, has in general resulted in a significant increase in prices and margins. While we expect the prices of some of these commodities to fall from current elevated levels, the profitability of these industries is likely to be higher on average going forward than in the past. **Bluescope Steel (BSL)** is exposed to this trend.

The next stage of reform is likely to be consolidation; although these industries are dominated by SOEs, they are dispersed between central and local SOEs and there are fewer local champions when compared to the large consolidated players in the western world. In general, this consolidation would be positive for both ex-China downstream producers and raw material producers.

In addition, while we were in Tangshan, one of the large steel producing regions, there was a lot of discussion about the current temporary cuts over winter to reduce coal/power usage and pollution levels around Beijing. By all accounts these cuts are having the desired effect, with clearer skies over Beijing. These temporary cuts are likely to cause short-term price dislocations but have the potential to become a consistent feature of future winter periods if the government can achieve its aim of reducing pollution. This, in conjunction with the general reduction in surplus steel capacity over recent years, will lead to stronger demand for higher grade iron ore over the medium-term in order for steel mills to maximise their output. This industry trend towards higher grade ores is positive for both **BHP Billiton’s (BHP)** and **Rio Tinto’s (RIO)** position in the industry.

While in China we also followed up with a range of industry contacts in the mineral sands sector. After a year immersed in this industry we have come away with the view that there is a reasonable prospect of a sustained upswing for the industry due to a long period of poor returns and underinvestment. While clearly things can, and will, change, current demand in downstream product markets is positive, with the trend towards higher quality products also seeing increased demand for higher quality commodity inputs, which plays into **Iluka’s (ILU)** product set. Any substantive new investment in the sector will take at least 2-3 years to come online and is likely be at a higher cost than existing capacity, supporting higher long term pricing.

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