CI AUSTRALIAN EQUITIES FUND
QUARTERLY REPORT

COOPER INVESTORS

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

JUNE 2013

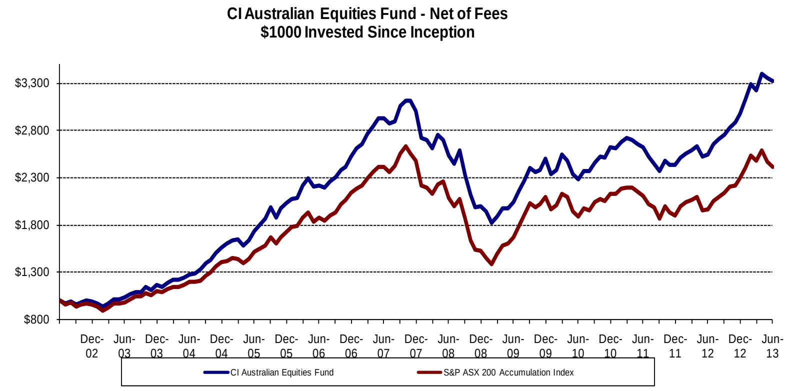
"Seven Deadly Sins
Wealth without work
Pleasure without conscience
Science without humanity
Knowledge without character
Politics without principle
Commerce without morality
Worship without sacrifice."
- Mahatma Gandhi.

"I sincerely believe that banking establishments are more dangerous than standing armies, and that the principle of spending money to be paid by posterity, under the name of funding, is but swindling futurity on a large scale." - Thomas Jefferson.

"In politics we presume that everyone who knows how to get votes knows how to administer a city or a state. When we are ill... we do not ask for the handsomest physician, or the most eloquent one." - Plato.

	****PORTFOLIO**	**BENCHMARK**	**VALUE ADDED**
ROLLING 3 MONTH	3.39%	-2.48%	5.87%
ROLLING 1 YEAR	31.85%	22.75%	9.10%
ROLLING 3 YEAR	14.23%	8.56%	5.67%
ROLLING 5 YEAR	6.55%	2.94%	3.61%
ROLLING 7 YEAR	6.95%	3.68%	3.27%
ROLLING 10 YEAR	13.57%	9.39%	4.18%
SINCE INCEPTION*	12.70%	8.36%	4.34%
SINCE INCEPTION^	272.25%	141.62%	130.63%

*Annualised
^Cumulative (4 July 2002)
**Before fees and expenses



Market and Portfolio Performance

The ASX200 Accumulation Index fell by 2.48% over the quarter but rose by 22.75% over the fiscal year. The portfolio returned 3.39% over the quarter and 31.85% over the year. Over the quarter the contributors to out-performance included News Corporation, Macquarie Group, QBE Insurance and Fisher & Paykel Healthcare. Conversely, earnings downgrades hurt the performances of Transpacific and Caltex, and a soft commodity price environment impacted on sentiment towards Rio Tinto.

For the first time in some years the Australian dollar showed some real weakness, falling from $1.04 to $0.92 against the USD and from Euro 0.81 to 0.71. This helped the performance of a number of industrial stocks with overseas earnings. While we would not profess to be able to predict the AUD, it has been apparent for some time that Australia is a very expensive country in which to live and work, and the strength of the AUD has been one of the factors behind the problems in our manufacturing sector, so the weakness is no surprise.

We have also witnessed a substantial rise in bond yields over the last three months as markets speculated on the winding down of the quantitative easing program in the USA. The US ten year bond yield has gone from 1.85% to 2.48%, and the Australian ten year bond yield from 3.42% to 3.82%.

The quarter also witnessed a large number of earnings downgrades by a widespread group of companies. Led by those in the mining services sector as miners push for lower costs in the current environment, we also saw downgrades for healthcare (e.g. Cochlear) and broader industrial companies (e.g. Transpacific Industries and Boral). This indicates to us that the domestic economy remains a very tough place to do business. Both in Australia and globally there still appears to be a disconnect between equities market indices and earnings growth/momentum, driven by central bank policies – the admirable aim of restoring economies and balance sheets via prolonged monetary easing has flowed into asset prices rather than the real economy. Continued equities market performance will require real revenue and profit growth.

The Portfolio

During the quarter we sold our small holding in **ALS Limited (ALQ).** Despite having a high regard for CEO Greg Kilmister and the business that he has built, a combination of declining trends and a full valuation gave us reason to exit our position. In regards to industry and operating trends, the following concerned us.

- The Minerals segment (geochemical and metallurgical testing) accounts for 60% of ALQ's operating profit. Within this segment, approximately 70% of the revenue is from minerals exploration (half green field, half brown field). Increasing pressure on mining exploration budgets globally is impacting this business with lower volumes and pricing pressure impacting margins. In May ALQ reported its FY13 results which outlined that 2H13 Minerals revenue declined 19% and operating profit declined 29%, causing Group operating profit to fall 15%. Minerals operating margins of 32% in 2H13 remain above our assessment of 'mid-cycle' margins and we expect earnings in this segment to fall further.

- The Energy segment accounts for 10% of ALQ's operating profit and consists primarily of exploration and metallurgical testing in the Australian coal industry. This industry faces substantial headwinds due to low coal prices, a high Australian dollar and high operating costs across the industry. At present, miners are reducing costs and discretionary spend wherever possible. From ALQ's perspective, "conditions are not expected to improve in the near future". With this backdrop, we struggle to see how earnings will improve in this segment.

- We don't see sufficient growth in earnings from the other 2 divisions (Life Sciences and Industrial) to offset the decline in earnings from Minerals and Coal, which account for 70% of ALQ's operating earnings. With a flat-to-down organic earnings outlook and the business being reliant on acquisitions to drive growth, we feel that a mid-to-high teens PE multiple is too expensive for the stock.

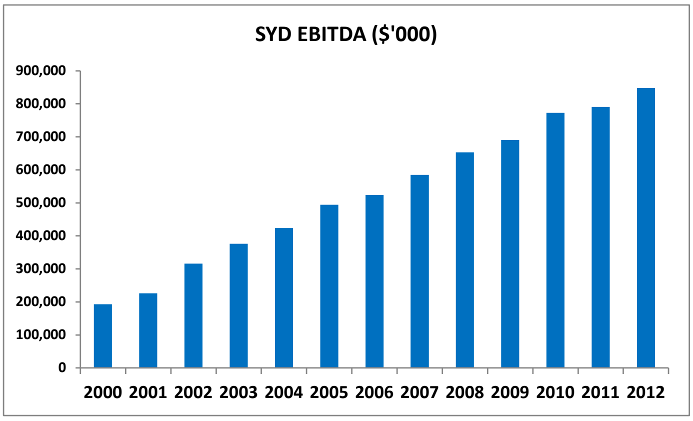
We also sold our remaining position in **Orica (ORI)**. The reasons for exiting our position are very similar to those enunciated above for ALS, namely that Orica has a very large exposure to mining, and in particular coal mining, which is coming under pressure globally as miners seek to cut their costs and capex budgets. In addition, Minova continues to struggle and the gold industry (to which Orica supplies chemicals) now looks to be under pressure as the gold price falls.

During the quarter we established a position in **Sydney Airport (SYD).** As discussed in our commentary on the Australian Infrastructure Fund (AIX) in the September 2012 quarterly, we are attracted to the economics of airports in Australia. While initially "missing" the strong share price performance following its "simplification" in Dec-11, we were given another opportunity to purchase SYD recently at what we considered to be an attractive price due to concerns around SYD's tax paying position. The key elements of our investment thesis are as follows.

- Following SYD's simplification in Dec-11 (asset swap and capital return), SYD's only asset is an 84.82% shareholding in Sydney Airport Corporation. SYD is now solely focused on extracting as much value from this asset as possible.

We consider SYD to be a “structural growth” infrastructure asset. Since 2000, SYD has grown passengers at 3.5% pa and EBITDA at 13% pa, even growing at 2.3% during the GFC in 2009, and has spent $2.7bn on capital expenditure at incremental returns of well over 20%. We believe that SYD can continue to deploy further capital over the coming years at attractive rates of return given the underlying demand for their asset.

Chart 1 – SYD EBITDA

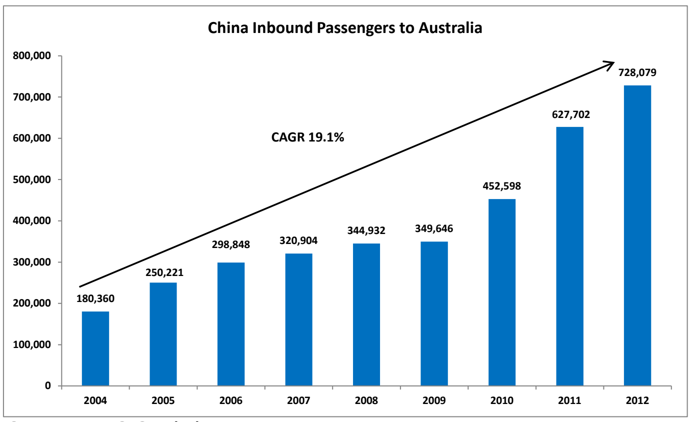


Source: Company data

- Favourable regulatory environment - Australian airports are the subject of a “light-handed” dual-till regulatory regime. This regime allows airports to commercially negotiate with airlines the returns on aeronautical capex (which delivers WACC type returns) and to achieve commercial returns on other capex (e.g. car parks, retail, property) which has typically delivered returns of over 20%. The regime is in place until the end of this decade and we believe that the Government is very satisfied with the outcomes of the regime given it has delivered the required capacity expansions that would have been more difficult to execute under public ownership.

- The key driver of profit growth for SYD is international passengers. While only accounting for ~1/3rd of passengers, they account for ~75% of EBITDA due to higher aero charges and retail spend. We are excited by SYD’s exposure to the emerging Asian consumer story and we believe it is one of the highest quality ways for Australian investors to get exposure to this theme.

Chart 2 – Chinese Inbound Passenger Growth to Australia



Source: ABS Statistics

- SYD should be able to deliver mid-to-high single digit growth in operating cash flows over the foreseeable future. At a current yield of 6.8% that is capable of growing mid-to-high single digits, we get over a double digit return and a risk profile that we believe is below that of the broader market.

The key risks to our investment include the following.

- Capacity constraints - We take comfort from the fact that SYD has been able to continue to invest and expand capacity over recent years and management believe that capacity is not an issue for the next 2-3 decades.

- Change in regulatory regime - While an adverse change in the regulatory regime could materially impact the valuation of SYD, we do not believe that SYD is currently "over-earning" and thus consider this to be a low probability event over our investment time horizon.

- Tax position - An adverse ATO tax ruling could potentially result in a back tax payment of several hundred million dollars and cut cash distributions going forwards by up to ~30%. While large, the back tax payment would represent less than 10% of our valuation. The cut in cash distributions would be largely offset by franking credits which we value highly due to their genuine economic value to Australian investors. We believe our base case valuation gives us an adequate margin of safety from our purchase price to take into account this potential issue, notwithstanding the potential for it to cause some market dislocation.

The portfolio continues to be positioned for an environment of slower economic growth. In Australia currency has, until recently, been a headwind and, as with the rest of the world, overall debt levels remain high and we expect an extended and ongoing period of de-leveraging. We would broadly concur with the sentiments of Bill Gross at Pimco – "wages continue to be dampened by globalisation, demographic trends (notably the aging of our society) and the retirement of the Baby Boomers, which will lead to a lower level of consumer demand. And then there's the race against the machine – technology continues to eliminate jobs as opposed to provide them." Thus our focus in the portfolio continues to be:

- companies with a sustainable and growing yield (Telstra, SYD);

- companies with structural (as opposed to merely cyclical) growth opportunities (Brambles, CSL, News Corp);

- companies focused domestically who are in the process of becoming more resilient and in control of their own fortunes despite the cycle (Caltex, Transpacific Industries, Fletcher Building); and

- companies who are able to benefit from a weaker Australian dollar.

Stock News

In June the **ASX** announced an unexpected 2:19 rights issue at $30 per share to raise $553m. This raising was completely unexpected by the market and caused the share price to drop by 6% on announcement.

The ASX decided to raise this equity to support the capital base of its futures and over the counter clearing businesses after European regulators increased the capital requirements for clearing houses that clear for European banks. In a response to the global financial crisis, regulators have tried to move the clearing of over the counter derivative transactions to transparent clearing houses. The aim is to reduce the risk of direct bank to bank clearing and settling that was exposed during the financial crisis. The regulators then recently decided that having increased the roles of clearing houses they would increase their capital bases so they did not become a point of weakness in the financial infrastructure. As many of the ASX clearing participants are European based it followed that the ASX needed to increase its capital base.

At this point the ASX equity base has increased without an immediate increase in earnings and therefore the return on equity for the ASX has decreased. Whilst it is by no means certain, we expect that the increased capital requirements will provide a further degree of protection against new competition in clearing, thus enhancing the likelihood that the ASX will be able to develop a profitable over the counter clearing business.

In early June **Transpacific (TPI)** released a trading update and also announced the resignation of the CEO. While the trading update was mildly negative (EBITDA guidance of $405-415m – down ~6% on FY12) it was not completely unexpected given the numerous profit downgrades from domestically exposed businesses in the preceding weeks. We feel that the magnitude of the profit decline is relatively small against what is an extremely tough operating environment and does not substantially change our positive view of the core underlying waste business. The resignation of the CEO provides the Board with an opportunity to appoint a CEO who can reinvigorate the focus on operations/strategy. We used the share price weakness to add to our position as we believe the multi-year turnaround story remains intact, albeit requiring some patience on our behalf!

Fletcher Building (FBU) hosted the first Strategy Day with the new CEO Mark Adamson. We came away from the day with a sense of optimism and a feeling that the business has significant latency to substantially improve mid-cycle earnings over the coming years. We were impressed with the divisional managers who appear to have a strong willingness to improve performance regardless of the economic cycle.

Caltex (CTX) hosted a site visit at its Queensland refinery in late June. It can be tough to glean too many great insights from an asset tour such as this. We do believe, however, that such tours can provide a good opportunity to meet middle management and get a feel for how well the business is conducted. Much of the update was not inconsistent with our expectations. Specifically, on the all-important marketing division, the slower growth rate is consistent with the commentary in our December 2012 quarterly where we stated "While we expect growth to moderate going forwards, we believe that the marketing/distribution business can deliver relatively reliable low-mid single digit growth". Our key concern regarding our investment in CTX is the capital expenditure required to drive this growth – management recently forecast a significant step-up in capex in this division despite the slower growth. We have some concerns around the incremental return on this elevated level of capex and this will be a key focus area in our forthcoming discussions with management.

Transurban (TCL) announced a move to Stage 3 in the F3-M2 project in Sydney. While acknowledging that TCL is in a strong position to negotiate a good deal on this project due to the ability to leverage its existing Sydney network (i.e. it is really the only party capable of delivering such a project), we believe that such green field projects carry a significantly higher risk profile than brown field expansions (such as lane widening) and as such we will closely monitor the risk parameters to ensure the overall group risk profile is not changing materially. We remain cognisant of Scott Charlton's background as a "deal maker".

The long awaited demerger of **News Corporation** into two separate entities took place during June. In the short time since the split it has proven to be positive for share price performance. The new News will hold the global publishing assets as well as Foxtel, and the nascent (but costly) education business. The Fox entity will contain the growth cable assets and European pay TV assets. We comment below on our findings from our recent trip to the US.

Aurizon Holdings (AZJ) refinanced its existing bank debt, replacing it with stand-alone debt facilities at both the corporate level and at its regulated below-rail subsidiary. The new facilities have increased the average maturity of AZJ's debt by 2-3 years and have attracted a slightly lower margin. However, the major benefit from the refinancing is to separately place debt against the regulated assets to give AZJ flexibility to further diversify its debt funding sources and to make it easier to sell a minority interest in the assets. Whilst we do not believe AZJ requires additional capital (in fact, we still believe that they have substantial excess equity capital) should they be offered an attractive price then it may make sense to sell a minority interest in the assets and return the capital to shareholders.

The 2-train PNG LNG project in which **Oil Search (OSH)** has a 29% interest continues to be on-schedule with the project now over 90% complete. Completion of the Komo airstrip in the PNG Highlands during the quarter was a major milestone. The LNG plants will be tested with commissioning gas later this year with first cargoes to leave PNG in mid-2014. We anticipate that OSH will receive substantial cash flow from the project from 2015 which should result in increasing dividend payments to shareholders. Ongoing appraisal activities over the next 1-2 years will determine whether the project has sufficient gas to construct additional trains.

Overseas Trip and Market Observations

During the quarter we visited the USA to undertake research on two of our largest holdings **Brambles (BXB)** and **News Corporation (NWS)** and to further investigate the US housing market recovery.

After meetings with BXB management, competitors, customers and other industry contacts we came away more confident in our BXB thesis. Specifically:

- The competitive landscape in the US pallets industry is the best it has been in many years – major competitor Peco continues to be rational, disruptive competitor iGPS continues to lose customers and entered bankruptcy during the quarter;
- Operating trends in the US pallets business are positive – improving asset productivity, strong cost focus (lowering cost to serve, utilising network scale advantage);
- Customer relationships and pallet quality continues to improve, albeit there is still room for improvement;
- The PMS whitewood business (acquired as part of IFCO in 2011) is highly strategic in helping industry conversion from whitewood (one-way) pallets to pooled pallets; and
- The multi-year structural growth opportunity for the US RPC business of converting the fresh food industry from cardboard packaging to pooled RPCs (14% penetration today, potential for >50%) is substantial if executed properly.

Our positive view on the growth potential of BXB is starting to show in the numbers with BXB reporting revenue growth of 6% (in constant currency) for the nine months ending 31st March 2013 and reaffirming its FY13 operating profit guidance. Encouragingly, revenue growth was 9% (in constant currency) in the important Pallets America segment which accounts for approximately 40% of BXB's operating profit and has been the source of market share loss and poor operating performance in previous years. With a strong growth outlook, improving operating trends, balance sheet latency and an operationally-focused management team that is delivering on its strategy, we remain positive on the outlook for BXB.

In preparation for the NWS demerger of its global publishing and Australian media assets, we met with the company and many of its competitors. In short, the industry and operating trends that we have written about in previous quarterly reports remain intact. Specifically:

- The pay TV ecosystem is not breaking down despite ongoing inflation in content/programming costs – consumers are able and willing to pay for valued content;
- Digital distribution of pay TV (time-shifting, on-demand) is a structural change from traditional linear distribution that is growing demand for content;
- There is still a large runway ahead in re-pricing of content as value continues to move 'upstream' to content owners – content/network margins still have room to increase;
- International opportunities are plentiful – global box office, increasing pay TV penetration; and
- Large media companies continue to narrow their focus to content production through divestments/demergers.

The parent company (to be renamed 21st Century Fox) will house some of the world's most valuable media assets, with >80% of earnings from content production. With a greater proportion of earnings now subscription-based and recurring, there is an argument that the stock should attract a higher multiple. This, combined with our view that the company can grow earnings per share at a double digit rate per annum over the medium-term, continues to make this company an attractive proposition. The demerged company (to be renamed News Corp) faces structural headwinds in its global newspaper businesses. However, it is very well capitalised (with $2.6bn of net cash), has over half of its earnings from non-newspaper pay TV and digital assets and appears to have a focussed management team that is confronting the structural issues head-on. We will continue to watch the evolution of this business with interest.

With the US housing market showing improvement every month, we sought to test the sustainability of the recovery and to determine whether we could find an attractive equity exposure to this thematic. We came away convinced that the housing recovery appears sustainable with solid fundamentals, with reasons including:

- Housing prices have bottomed and are up 10% from 2012, although still 20% below 2006 peaks – important for confidence and momentum;
- Affordability is near all-time highs with 30 year fixed mortgage rates of 3.5-4% (recently jumped up to 4.5% towards the end of the quarter);
- An increase from the current 900k starts back to 60 year average of 1.5m starts is supported by recovering household formation rates, existing housing inventories being at 15 year lows and lack of building over the past few years;
- The aspiration of home ownership is still very much alive in the US, it is just that the capacity to own has been impaired given the economy; and
- There was more optimism from contacts/meetings compared with our last US trip in September 2012.

Unfortunately there are only two ASX-listed stocks with material direct exposure to the US housing market. James Hardie (JHX) generates over two-thirds of its earnings from selling fibre cement building products in the US and Boral (BLD) is the largest brick and clay tile manufacturer in the US. BLD's US segment accounts for approximately 15% of its asset base but it has generated losses for the last six years. Although this segment is forecast to return to profitability once housing starts increase beyond 1.1m, the headwinds facing its Australian construction materials and building products segments and lack of balance sheet flexibility outweigh the positive US exposure and hold us back from investing in the stock.

We wrote about the attractiveness of JHX's business in our September 2012 quarterly report but concluded that the majority of the upside from a housing recovery was already reflected in the share price. This trip did nothing to change our view on the stock. In fact, we actually think the next decade will be harder for JHX than the last ten years. The industry is more competitive, we expect market share growth to slow and there are many reasons why margins are likely to be structurally lower than historical (and market forecasts). We see parallels to the issues that Cochlear (COH) is experiencing in developed markets, that is as penetration increases, previous growth rates will be harder to achieve with the result being lower growth (for same margin) or lower margin (for same growth). Given this and the fact that only 30% of JHX's revenues are from new US housing construction, the current share price is too expensive for us. The best exposure we see to this thematic is actually through our holding in BXB as an improving housing market should result in higher lumber prices which helps the competitiveness of pooled pallets over whitewood pallets.

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