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.

JUNE 2017

"Bubbles take time to mature. They do not inflate overnight. The current one has seen enough preparation. In particular, bubbles begin only after a long period of positive asset returns has reduced the perception of risk to an abnormally low level." Marc Faber

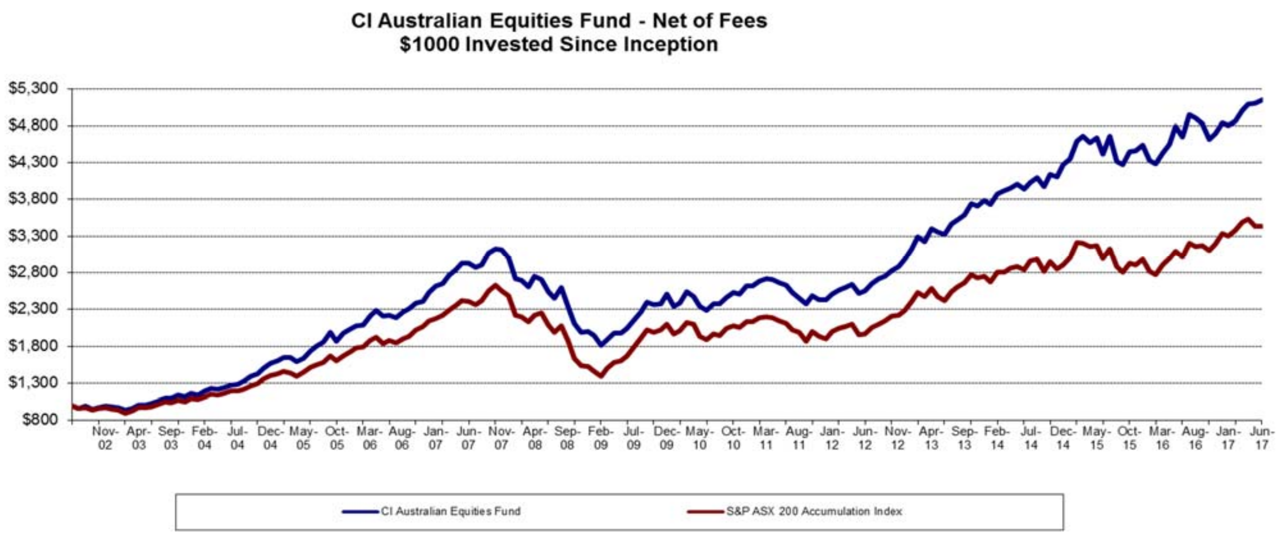
"Would I say there will never, ever be another financial crisis? You know, probably that would be going too far, but I do think we're much safer, and I hope that it will not be in our lifetimes, and I don't believe it will be." Janet Yellen

"I think the government solution to a problem is usually as bad as the problem and very often makes the problem worse." Milton Friedman

"The American Dream has become a death sentence of drudgery, consumerism and fatalism: a garage sale where the best of human spirit is bartered away for comfort, obedience and trinkets. It's unequivocally absurd." Zoltan Istvan

	**PORTFOLIO	#BENCHMARK	VALUE ADDED
ROLLING 3 MONTH	3.16%	-1.58%	4.74%
ROLLING 1 YEAR	11.76%	14.09%	-2.33%
ROLLING 3 YEAR	10.75%	6.63%	4.12%
ROLLING 5 YEAR	16.50%	11.81%	4.69%
ROLLING 7 YEAR	13.49%	8.94%	4.55%
ROLLING 10 YEAR	6.91%	3.61%	3.30%
SINCE INCEPTION*	12.77%	8.59%	4.18%
SINCE INCEPTION^	505.77%	244.01%	261.76%

*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 fell during the quarter (-1.58%), reflecting domestic issues relating to the banks, and weakness across the retail sector as consumer spending slowed and concerns emerged about the entry of Amazon into Australia. In addition, commodity prices also trended lower.

After the Brexit vote in the UK last year and the US elections that followed, global investors started to price a more favourable economic environment globally. More recently, some of this optimism has faded following elections in the UK and challenges the Trump government has faced passing legislation in the US.

Bond yields increased sharply in June following remarks by several central banks that the period of historically low interest rates and unprecedented central bank intervention in bond markets would start to normalise. The Australian 10-year bond rate rose by over 20bps in June to 2.6% taking the annual increase to over 60bps. Australian bond yields appear to be following the US 10-year bond which rose by more than 80bps to 2.3% over the 12 months to June 2017. This has made for a very volatile year for bond-like equities in sectors such as property trusts, infrastructure and utilities.

In Australia, weakness in several discretionary retailers points to softness in consumer demand in the face of record levels of household debt and weak wages growth.

Key contributions to portfolio performance during the 3-month period included Sims (improving outlook for earnings), Boral (continued recovery in US housing, solid performance of Headwaters), Fisher and Paykel Healthcare and Iluka (rising commodity prices).

Portfolio stocks that performed poorly were the banks generally (regulatory issues) and Wesfarmers (Coles profits under pressure and the news that Amazon is finally planning an entry into Australia).

The Portfolio

During the quarter, we participated in the equity raising by **Bega (BGA)**. Proceeds will be used to repay debt following the very recent acquisition of Vegemite and related products from Mondelez. Post raise, Bega's balance sheet will once again be "under-geared" relative to both dairy peers like Fonterra and Murray Goulburn and international brand companies like Kraft Heinz and Mondelez. This positions the company to build on both its dairy business and its relatively newer branded goods business should opportunities arise. The portfolio position is only small but we anticipate future opportunities to increase our holding as the company grows.

We also bought **Rio Tinto (RIO)** and **Origin Energy (ORG)**. Like most other mining companies, RIO benefitted from the rebound in commodity prices, particularly iron ore, which has been predominantly driven by better-than-expected steel production in China and high margins in the steel sector over the past twelve months. This, combined with productivity improvements over the past two years, has put the company's balance sheet in a strong position. As the share price came back with the drop in the iron price from $90 to under $60, we initiated our position in the stock. The world in general, and the ASX in particular, is very long financial risk – in this environment we are looking to diversify into hard assets. Even in a lower commodity price environment RIO will still generate strong cash flows. There are further asset sales (predominantly coal assets) to come that will further de-gear the balance sheet. The portfolio is simplified and is focused on long life and low cost assets in iron ore, copper and aluminium. The new CEO, Jean-Sebastien Jacques, has been active in making portfolio changes and is focused on extracting value out of its existing asset base. From this position of strength, the board and management can be patient and should retain a strong balance sheet for opportunities when they arise.

The purchase of ORG is based on the thesis of simplification, balance sheet improvement, and taking advantage of current industry trends. The new CEO Frank Calabria was given a mandate to transform the company's performance. He made a rapid start post his appointment in late 2016 by re-organising the executive leadership group and is now focused on several initiatives that will both improve gearing and drive operating performance:

- Sale of gas assets – the business has been named "Lattice Energy"
- Reduction of cost in the core Origin business
- Reduction of cost and capex in APLNG
- Growth in volume (and market share) in gas.

Our valuation of ORG is above today's share price, and there is latency in the initiatives described above, as well as in the ability of ORG to capture the benefits of today's gas and electricity prices. One of the risks facing both ORG and other companies in the gas and electricity sector is the government. After some years of lax foresight and a total lack of coherent, comprehensive and inclusive (i.e. including the States and Territory) energy policy, governments of all persuasions are now fighting a rearguard battle to contain a politically and economically difficult situation. The risk here is that the government decides to (re)regulate the industry in an attempt to drive down prices for energy consumers.

In June, **Link Administration Holdings (LNK)** announced the acquisition of Capita Asset Services (CAS) from Capital plc in the UK for A$1.5 billion, which is significant in the context of LNK's A$2.8b market capitalisation. CAS provides a broad range of financial and administrative services in the UK & Europe that are broadly consistent with LNK's core skillset. The acquisition aligns with the company's growth strategy, although we note that new businesses and geographies increase complexity and risk. The transaction was part funded by an A$883m 4-for-11 rights issue, with the residual funded by debt costed at around 3% (pre-tax). The deal is expected to be completed at the end of calendar 2017 following regulatory approvals across several jurisdictions. We participated in the issue. LNK has not paid a cheap price for these assets and will need to extract the stated synergies to make an adequate return. We are also mindful of the fact that LNK are still in the process of extracting synergies from the Super Partners acquisition in their core fund administration business, and have recently acquired a further stake in PEXA, the online property exchange business – management have a number of balls in the air and landing them all successfully will take effort and focus.

We sold our position in **Tabcorp (TAH)** during the quarter. Although we had exited most of our position prior to the date on which the Australian Competition Tribunal (ACT) made public its decision on the Tatts Group (TTS) merger, we were nevertheless a little surprised the stock did not rally or rerate on a positive decision. Rather the decision was somewhat overshadowed by a less than inspiring trading update, encompassing several of the reasons why we sold out, and as the market digested the numbers was followed by underperformance. Disappointing performance in its domestic Luxbet business, a large increase in the cost base of the company, low overall revenue growth, and ongoing larger-than-expected losses in the UK were key reasons for the subsequent stock price fall. In addition, we suspect the operating performance of TTS has not improved in either of its lotteries or wagering businesses meaning that TAH will need to find at least the $130m pa of stated synergies to justify the very high price it is paying to merge. As a footnote, we note with interest the appeal lodged by the ACCC against the decision of the ACT. TAH would appear to be stuck between a rock and a hard place – pay a high price to turn around an underperforming business, or if the appeal succeeds then having to vastly improve its own performance in the face of tough competition from the international on-line players. And that is of course assuming the Macquarie consortium (second bidder for TTS) has really gone away.

We also exited our position in **Iron Mountain (INM)**. Although we believe management will hit their synergy targets, the stock had hit our valuation and lacked latency beyond this point. And in an environment where interest rates look to have bottomed for the time being the balance sheet remains heavily geared at 5X Net Debt/EBITDA.

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General Industry Observations

As usual, we undertook several trips both domestic and offshore. In particular, Perth remains of interest. We visited several companies in the mining services sector:

- Mining services is more buoyant now vs 12 months ago.
- A key driver of the improvement is a pick-up in work from the gold sector.
- Gold prices have been high and stable for a couple of years, helping fund several projects for the junior/mid-tier miners.
- Most of the smaller gold miners are heavy users of contractors.
- We visited an unlisted equipment rental and maintenance group that has seen a 35% increase in utilisation hours since November last year. They were also very bullish on the outlook for maintenance. Operators are running their existing equipment for longer to avoid capex which is increasing the market for maintenance contracts.
- One contractor commented that they had 60 investor meetings in CY16. So far in CY17 they've had 130.
- In general, balance sheets are much sounder now across the services sector.
- Contractors' share prices have moved a long way, and well in advance of the anticipated earnings uplift.

We also had several meetings relating to the Perth office market:

- Perth CBD vacancies appeared to have peaked late last year at 25%, falling slightly this year.
- This is not as bad as the early 90s when vacancies reached 30%.
- Incentives are still very high at 50%. The result is net rents in the CBD are now below 2007 levels (i.e. over 10 years they have gone backwards).
- West Perth vacancies continue to increase above 20% and are likely to increase further. This is concerning considering CBD vacancies, i.e. as leases expire in West Perth more businesses are likely to move to the CBD (we also think any bank exposure to these asset owners is concerning).
- Supply has added significantly to the problem; 2015 was the peak for office supply additions for the past 25 years.
- More supply is coming as well (Woodside and Chevron buildings).
- Downsizing appears to have worked its way through now; there has been a modest uptick in enquiries.
- The biggest issue in the CBD is the "B" grade assets given vacancies are still high in "A" grade and premium.
- Asset sales have been minimal; institutional ownership of assets has increased significantly but private money has been looking around.

We are constantly reminded that companies do not operate in a vacuum and despite our best efforts at managing risk in the portfolio, companies can be impacted by "left field" events. While these risks are part and parcel of investing in equities markets, we remain vigilant to particular concentrations in the portfolio. There have been many examples of what we would term "sovereign risk". For the most part investors associate such risk with government actions (such as repudiating debt obligations or otherwise confiscating assets of investors or increasing taxes on investors) of less developed countries (PNG, Africa, Asia, South America, Russia) and invest in the knowledge that unfavourable events can and do occur (e.g. the recent Tanzanian decision to acquire a 16% free carried interest in all projects operating under a mining licence, to increase both the royalty rate (from 4% to 6%) and impose a 1% clearing fee). Sadly, these types of risks also apply in Australia, namely:

- During the quarter both Federal and State (SA) governments took the opportunity to announce new taxes on Australia's 5 largest banks;
- Various State governments recent increases in taxes on overseas residential property investors;
- The recent Australian government decision on domestic gas reservation;
- The ill-fated attempt by the government to impose a resources tax;
- The ever-present ongoing change in reimbursement rules in many areas of the healthcare and aged care sectors.

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Trip Notes

China

We travelled throughout China in April. The focus of our trip was on the iron ore, steel, mineral sands and gas markets and specifically assessing industry dynamics, the demand environment and policy initiatives. One thing that we are always reminded of when we visit China is how policy driven the economy is. This adds a layer of uncertainty to any analysis of the country, from an outsider's perspective, and is why constant observation is critical from an Australian investor's perspective given the importance of China to many facets of Australia's economy.

The most notable change to when we visited China last year was the significantly increased focus on environmental policy. And not just in the political rhetoric, which we have been hearing for some time, but on the ground policy implementation. This was pervasive across almost all industries we encountered and it became clear that the central government has taken control of the process and put some teeth behind its environmental policy. The seriousness of the enforcement was highlighted by several companies pointing out that the central government is sending its own inspection teams into the factories. They stay on site and install monitoring equipment and will close the factory down if it does not meet the standards. Additionally, the environmental standards that are required to be met are also gradually rising.

The effect this more rigorous enforcement of environmental policies is having on industry is meaningful - increasing capital requirements and operating costs, squeezing out smaller or weaker players and resulting in consolidating industries.

This is likely to prove positive for longer-term profitability in a number of industries to which Australian companies have exposure, namely steel, nitrogen chemicals, aluminium and titanium dioxide. These environmental policies are also significantly increasing the demand for gas in the Chinese market, which has the potential to tighten the global LNG markets sooner than is currently being anticipated.

Overall, we came away from China with the view that the economy was on a solid footing with the government actively engaged in ensuring the stability of the economy. Although the economic strength seen in the first quarter of 2017 is unlikely to be sustained, particularly given the policy measures that are being put in place to slow the residential building market, infrastructure investment will continue to grow and consumer expenditure will be supported by strong employment levels (unemployment was below 4% in the first quarter and we heard numerous reports of shortages in skilled workers across several industries). With Xi Jinping likely to have completed the consolidation of his powerbase by the time of the 19th Communist Party Conference later this year, it is unlikely that the current course being pursued will alter substantially into the future.

US Steel

In June, we participated in the BlueScope (BSL) and Sims Metal Management (SGM) site tours through the US as well as meeting with a number of other participants in the steel industry while we were there.

The US steel industry is undergoing a bit of a renaissance. The key driver of this has been the significant increase in anti-dumping activity undertaken by the US Government. This has brought higher steel making margins and capacity utilisation to the industry. There was much discussion regarding the Section 232 review that is currently underway and the potential for more aggressive trade barriers in the steel industry. Although on face value it would appear to be positive for the US steel industry, additional protectionist measures could attract similarly aggressive responses from other major steel producing countries, the unintended consequences of which are difficult to judge and will require close monitoring. We note that the Australian government appears to have a done a good job at last week's G20 meeting in negotiating an exclusion from the proposed tariffs for the small amount of steel exported from Australia.

Steel demand is solid, with construction demand strengthening, auto still solid, although coming off record high levels, and the overall economic environment stable for the time being.

The highlight of the BSL tour was the North Star steel making operation in Ohio. The plant is positioned in a geographically advantaged location with the vast majority of both their scrap supply and customers within a 250-mile radius of the plant. North Star has a very engaged management and workforce, a result of remuneration structures that are directly linked to profitability and productivity and a strong culture that encourages staff to behave like owners of the business. We met with a wide range of operational managers across BlueScope's businesses and were struck by the passion that they exhibit when talking about their business and the opportunities ahead of them. Across the company many employees have been with Bluescope for a long period of time and are similarly engaged.

SGM took us to see their New Jersey and Chicago operations. Management, both senior executives and operational, impressed with the depth of their knowledge of the industry and their businesses. The New Jersey operation has a strong logistical competitive advantage that is difficult to replicate due to ownership of the port infrastructure. SGM are currently undertaking several capital investment programs that appear relatively low risk, as they are effectively increasing the value of the scrap they sell through additional processing to further separate and concentrate material.

Scrap markets remain somewhat subdued relative to history, but have been improving in recent times and SGM are well placed to capture significant benefits from any improvement in volume when it comes.