CI AUSTRALIAN EQUITIES FUND
QUARTERLY COMMENTARY REPORT

COOPER INVESTORS

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 2018

"Doing well is the result of doing good. That's what capitalism is all about." Ralph Waldo Emerson

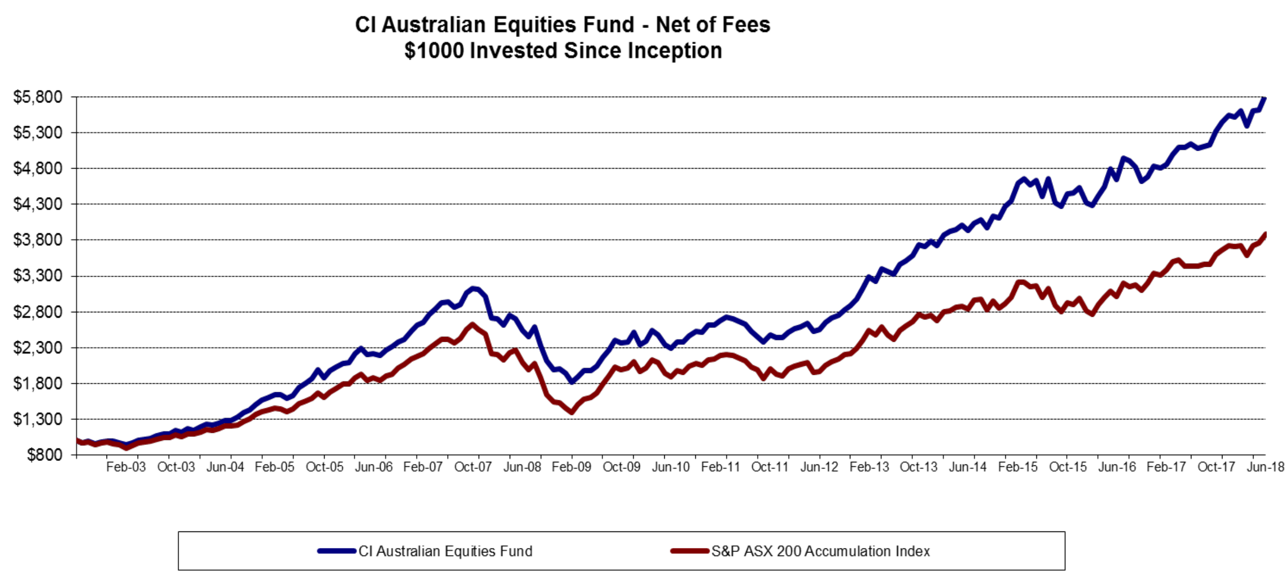
"Question everything. Learn something. Answer nothing." Euripides

"I noticed that the dynamic range between what an average person could accomplish and what the best person could accomplish was 50 or 100 to 1. Given that, you're well advised to go after the cream of the cream. A small team of A+ players can run circles around a giant team of B and C players." Steve Jobs

"Throw out your conceited opinions, for it is impossible for a person to begin to learn what he thinks he already knows." Epictetus

	**PORTFOLIO	#BENCHMARK	VALUE ADDED
ROLLING 3 MONTH	8.51%	8.47%	0.04%
ROLLING 1 YEAR	14.58%	13.01%	1.57%
ROLLING 3 YEAR	11.04%	9.04%	2.00%
ROLLING 5 YEAR	13.27%	9.98%	3.29%
ROLLING 7 YEAR	13.35%	9.12%	4.23%
ROLLING 10 YEAR	9.86%	6.40%	3.46%
SINCE INCEPTION*	12.88%	8.86%	4.02%
SINCE INCEPTION^	594.11%	288.78%	305.33%

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



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Market and Portfolio Performance

The market finished the financial year on a strong note, rising 8.5% over the quarter, to be up 13% over the year. Commodities continued to be resilient with oil (Brent) continuing its strong rise to $77, from $69 at the beginning of the quarter and from $48 one year ago, while copper and iron ore prices also rose over the year but less strongly. The AUD fell from 77c to 74c against the USD. In these circumstances it is not surprising that BHP and Origin Energy were among the stronger performers in the portfolio, as was CSL (earnings upgrade midway through the quarter) and Wesfarmers (exit from UK on better terms than anticipated). Underperformers over the quarter included Boral (weather related earnings downgrade), Link Group (May budget announcement - see below) and Brambles (ongoing concerns about its ability to recover input cost increases).

It is interesting to note Australia was one of the top performing markets globally, significantly outperforming Asia (Shanghai Composite -11.4%) and other emerging markets in Europe and South America. Contribution across sectors in the ASX200 was broad-based with Energy, Mining and Health sectors among the best performers. The poor performance in Asia appears to reflect concerns of an escalating trade war between China and the US, with China perceived to be most impacted.

In the last quarterly report we wrote about **Wesfarmers' (WES)** new CEO Rob Scott and his decision to demerge the Coles business. During this last quarter WES revealed its decision to exit the UK, and shortly thereafter the completion of the divestment to restructuring specialist Hilco Capital, recording a loss on disposal but importantly avoiding ongoing lease liabilities. Rob Scott is showing himself to be a man of considered action and we would anticipate further announcements from him over the next months. We continue to believe that post the de-merger of Coles (and the sale of their coal assets), Wesfarmers will be in a position of financial strength, with a strong balance sheet, good cash flow and a reinvigorated management team.

We look forward to the demerger of Coles later in the year, noting that history provides a very positive back drop to demergers/spin outs:

- Bluescope Steel (ex BHP), Recall (ex Brambles), Dulux (ex Orica), South 32 (ex BHP) have all done well
- Onesteel (ex BHP) did not end well but its share price performed impressively for a period post demerger

Link Group (LNK) were buffeted by surprise changes announced in the May Budget release. The government released proposed changes relating to the treatment of inactive superannuation accounts from 1 July 2019, proposing that for member balances less than $6,000 and where there has been no contribution for 13 months, the account balance will be transferred to the Australian Taxation Office (ATO) and the account closed. This would potentially have a significant adverse impact on the number of member accounts administered by LNK. The company was unable to quickly disclose the number of such accounts on its books and only a week later revealed that in its current form, with no offsets, the new legislation would cost LNK $55m in revenue. Perhaps as disappointingly, along with its initial post budget announcement, LNK also revealed it had lost a contract for the provision of fund administration services worth 1% of group revenue – our concern arises from whether the company with a lot on its plate (delivery of not insignificant cost synergies promised on listing, integrating a large acquisition in the UK) may have taken its eye off the ball in its core business.

In June **Clydesdale Bank (CYB)** announced an all-share offer for Virgin Money (VM) based on the proposed terms of 1.2125 CYB shares for each VM share, which had been agreed by the Boards of both companies. Upon completion VM shareholders will own 32% of the merged entity and two VM board members will have seats on the Board. The offer is subject to shareholder and regulatory approval, and is expected to complete in the fourth quarter of this year.

The merged business will create the sixth largest bank in the UK and will have sufficient scale to be a genuine national competitor. This is underpinned by exclusive and perpetual rights to the ubiquitous Virgin Money brand in the UK, a national distribution footprint, leading digital capability and a full product range across both the retail and SME sectors. CYB will be the only one of the so-called 'challenger' banks with these attributes and to us it very much has the feel of an old-world business strategically positioning itself for the future, in this case a bank with a 175 year heritage preparing for a world of open banking and fintech collaboration.

The merger is expected to be materially EPS accretive based on the £120m of cost synergies identified, representing around 12% of the merged business' estimated underlying cost base. Given management's track record on cost-out we suspect this may well be conservative. In addition, there are other value latency options around cost savings from avoided VM digital bank spending, revenue and funding synergies, and some further regulatory capital benefits for VM. We expect management will provide a more detailed 'roadmap' of these opportunities post completion of the merger.

While we are typically cautious around companies embarking on supposedly transformative M&A, we think this merger makes sense both financially and strategically, particularly given the complementary nature of product lines and geographic exposures. At completion, CYB will also have largely completed its initial three year IPO journey which will give management the bandwidth to undertake what we understand is a relatively low-complexity integration process. The strategic optionality and value latencies noted above mean we are confident that over time this merger will be value accretive not just EPS accretive.

Portfolio Changes

No substantive changes to the portfolio were made during the quarter. However we did undertake the following:

- Added to our positions in Wesfarmers, Woolworths and Orica
- Reduced our positions in Bluescope and Fisher & Paykel, predominantly for valuation reasons
- Reduced our position in LNK due to the uncertainty engendered by the budget as per comments above
- Sold out of our small position in AMP as findings emanating from the Royal Commission were unexpected, did not reflect well on the company, and lowered our conviction in the stock.

Industry Observations

In our experience New Zealand (NZ) produces a lot of high quality companies and management teams, and the NZ retirement sector is no exception. We have invested 'across the ditch' in the NZ retirement sector for many years in **Ryman Healthcare (RYM-NZ)** and **Summerset Group (SUM-NZ)**. However we have had relatively little exposure to their listed peers in the Australian market despite them being exposed to the same demographic tailwinds. We thought it might be informative to outline some of the reasons why we have preferred the NZ listed operators to-date.

Focus: RYM and SUM only do one thing – build, own and operate integrated retirement villages. In Australia there are few dedicated listed operators with most being part of a larger diversified group (e.g. Lendlease, Stockland). We think the likelihood of success is better for companies that maintain a tight circle of competency.

Owner-operator mindset: The origins of many Australian retirement village operators are as property developers primarily focused on development profits compared to the owner-operator mentality in NZ. This is an important distinction for businesses that are long-term in nature and deal with residents (and their families) in the final years of their lives. It's hard to convey this nuance on paper but when you have been to as many retirement villages as we have, you know it when you see it.

Continuum of care: RYM and SUM both operate integrated retirement villages which combine independent living and residential aged care at the same facility. This is referred to as offering a 'continuum of care' because residents can stay in the same village as their aged care needs change, allowing them to 'age-in-place'. In our view this is critical to the customer value proposition as it drives the 'needs-based' nature of their business, that is, residents are moving in because they need aged care (or soon will) rather than as a lifestyle choice. We think this underpins demand for these villages and makes the business model more resilient in a downturn. By way of example, in FY18 NZ real estate volumes were down 14% but RYM resales volumes (i.e. existing units) were up 15%.

Importantly, the ability to provide 'continuum of care' impacts unit pricing, age of entry, turnover rates, elasticity of demand, resales values and waiting lists. All of which drive the economic engine of the business.

In contrast many Australian retirement village operators have a lifestyle focus and offer little to no aged care services. So when residents require aged care they typically have to leave their village and enter a residential aged care facility at another site. This is a complicated and stressful process at what is often a very emotive time for the resident and their family.

Simplicity and certainty: Resident contracts in Australia are complicated, legalistic and typically loaded with a litany of different types of fees. In comparison NZ resident contracts are simple with only 3 main charges for residents being entry price, the deferred management fee (DMF) and the weekly fee. Together with the continuum of care the simple NZ contract structure provides residents with certainty and security which really resonates with prospective residents.

Greenfield development: The key reason RYM and SUM have been able to grow their retirement village portfolios significantly over many years without the need to raise additional equity is because of their greenfield development capability. This allows them to efficiently recycle capital from a completed village into building the next one, and so on. This has a powerful compounding effect over time and doesn't expose them to the risk of overpaying for acquisitions and loading the balance sheet with 'core' debt, which turned out to be a significant issue for some operators during the GFC.

Management and culture: We think the management teams at RYM and SUM are best in class. Their owner-operator culture is reinforced by long-tenured management with deep industry expertise. As a case in point, RYM has only had 3 CEOs since the business started in 1984, and has a culture guided by the principle of '*It's got to be good enough for mum*'.

Track record: RYM and SUM have built a strong track record of operating performance and generated significant value for shareholders over the past 3 years, whereas their Australian counterparts have been poorer performers in both a relative and absolute sense (as shown in the chart below).

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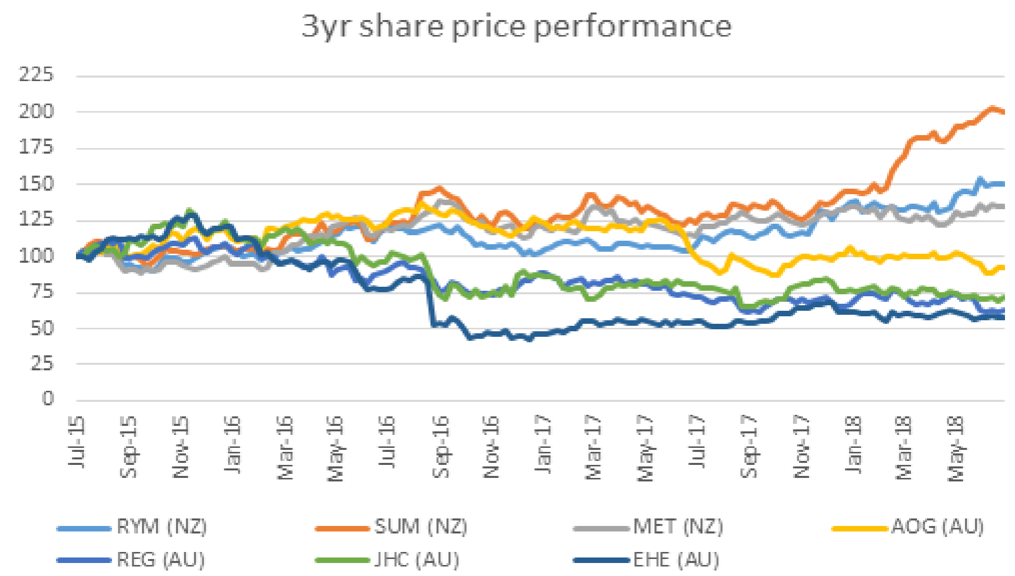
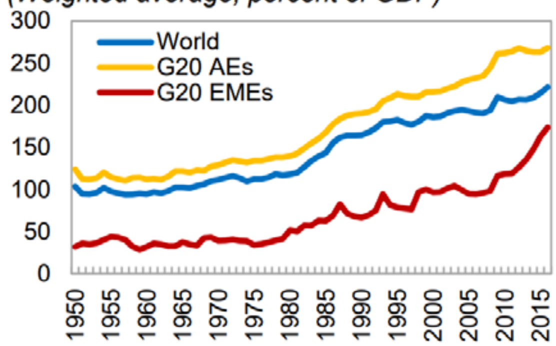


The banking Royal Commission (RC) continued during the quarter with the main focus on financial advice, and loans to small and medium enterprises. There have been forests worth of paper written on the proceedings to date so we will not dwell on the issue other than to note likely impacts of the RC on the banking sector will include:

- Tighter lending criteria and thus potentially slower growth in lending volumes
- Higher risk aversion on the part of management and Boards in light of statements made by the RC and the Treasurer
- Higher regulatory and compliance cost

During the quarter the International Monetary Fund ("IMF") compiled a report with a detailed set of historical data of debt levels across the world, starting in 1950. Even post the GFC, debt levels continue to rise (country weighted average) when measured relative to GDP, underpinned by central bank policies of near zero interest rates:

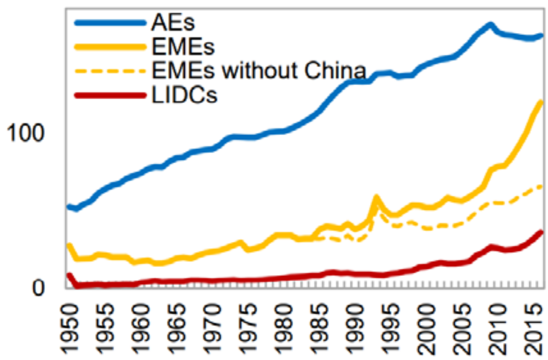
Figure 9. Total Debt: World and G20
(Weighted average; percent of GDP)



Source: IMF

However, the most significant increase in recent years has been in emerging market private (non-government) debt, driven by China:

Figure 11. Private Debt by Income Group
(Weighted average; percent of GDP)



Sources: Global Debt Database; and authors calculations.
Note: The weighted average is calculated using and unbalanced sample comprising 158 countries.
AEs=Advanced Economies; EMEs=Emerging Market Economies; LIDCs=Low-Income Developing Countries.

On the positive side, debt in emerging markets is still well below Western countries (~100bps difference in total debt % GDP). However, the rate of growth is the concern – since 2005, per the IMF report, *"China has accounted for almost three-quarters of the growth in global private debt".* However, some caution is warranted with this observation, given the inability to confidently separate China's government and private debt.

China is clearly important for Australia, and Australian stocks. The obvious exposures are direct via mining and resource companies. However, just as important are the indirect exposures which include property, banks, tourism, and construction to name just a few.

While so far the Chinese government has managed this growth in debt without significant issue, the debt has clearly supported China's growth in recent years. It suggests China has a delicate tightrope to walk as it rebalances to a domestic-focused economy from an export-focused economy, to consumption growth from capital growth and as it deals with a changing relationship with the US.

Trip Notes

During June we visited Singapore where the Asian operations of a couple of portfolio companies are based. One of the companies we visited was Lendlease (LLC). LLC have been in Asia for over forty years, initially with a presence in a number of countries but now in a more focused manner. The company aims to have up to 20% of its capital invested in Asia albeit today it is a much smaller number, circa 7%. In addition the current ROIC in Asia is well below the group average, the expectation being that as the two main developments referred to below come to fruition over the next few years Asian ROIC will rise.

- LLC are now focusing on gateway countries/cities in Asia (Singapore, Kuala Lumpur, Shanghai and Japan) where they can bring their full model of design, develop, construct, capital partners, and manage the assets on completion, where the projects have large mixed use requirements, and where the demographics for attracting talent are favourable.

- LLC have commenced such projects in each of Singapore and Kuala Lumpur with end values of $3B and $2B respectively. These projects are due for delivery progressively over the next 2-4 years.
- In Singapore LLC have bid for 6 mixed use projects and won 3, a strong hit rate and prospective in light of projects currently on the government drawing board.
- Unlike the rest of the world, in Singapore LLC pay for the land up front. Partially offsetting this capital impost is the fact that as the land is acquired from the government who have agreed the project specs, the speed of execution and time to completion is much shorter.
- In Shanghai LLC are building and operating their first retirement village in the region under a model a little different to that in Australia. Essentially LLC, having bought the land on better terms than normal as it is designated/zoned for retirement, will build the village and sell life memberships, making a construction and development profit. Ongoing service fees generate a return on the capital remaining employed in the central village infrastructure. Success in this first village would likely see further senior living projects in Shanghai.
- In Japan, having built many thousands of telecommunications towers over the last fifteen years, LLC are now looking to develop and own/lease back towers. Historically these towers have not been shared by service providers. With a fourth mobile operator licence recently awarded, there is now the potential opportunity to acquire and develop shared infrastructure as is common in other parts of the western world. However the opportunity, such as it is, is long dated still.

We also visited a number of iron ore traders and marketing teams whilst in Singapore. The iron ore price at above $60 has been higher and more stable than most expectations despite high profitability of the miners, healthy seaborne supply and high port inventory levels. Interestingly a price above $60 would have historically incentivised higher domestic production in China but latest data shows that production rates are to date relatively flat. This seems to relate to the supply side reforms enacted in China as we have seen in other industries like steel, coal and aluminium, and higher costs due to stricter environmental policy. Although the inventory levels at ports in China remain high, a large proportion of stock is low grade iron ore and more iron ore is being blended at ports by Vale and domestic traders. Chinese domestic consumption has been stronger than expectations driven by strong property and manufacturing demand, and world steel production has also been strong.

Although the current benchmark 62% iron ore price is positive for the likes of Vale, Rio Tinto and BHP Billiton, the discount applied for lower grade ore remains stubbornly high, oscillating at around 30-40%. This impacts Fortescue Metals in particular so by investing in a new mine (Eliwana) they aim to replace some depleting production at its existing mines, and to increase the iron content over time. The high discount on low grade is driven by both cyclical (high steel margins, robust steel demand) and structural (steel capacity cuts, winter shutdowns) factors. As we have written in previous quarterlies, our expectation is that steel margins are likely to normalise downwards over time given current profit levels, which should also lead to a decline in the low grade discount and a lower overall iron ore price.

Our observation is that current conditions remain reasonably benign for both steel and iron ore as explained above. Supply forecasts are well covered, but what is less certain over the medium to long term is China's demand for iron ore as the economy matures and scrap output increases, and the ability of other developing economies to absorb this. In addition we note with caution the debt issues referred to above. Thus we continue to take a conservative view and our long-term steel margin and iron ore price assumptions, which are below spot rates, remain unchanged. What is certain however is that, notwithstanding rising costs in the mining sector, the balance sheets of BHP and RIO are improving by the day. We would expect the balance sheets of both companies to be close to net debt free post their remaining asset sales (Grasberg in the case of RIO, and US onshore oil and gas in the case of BHP).

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