CI AUSTRALIAN EQUITIES FUND
QUARTERLY REPORT

COOPER INVESTORS

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

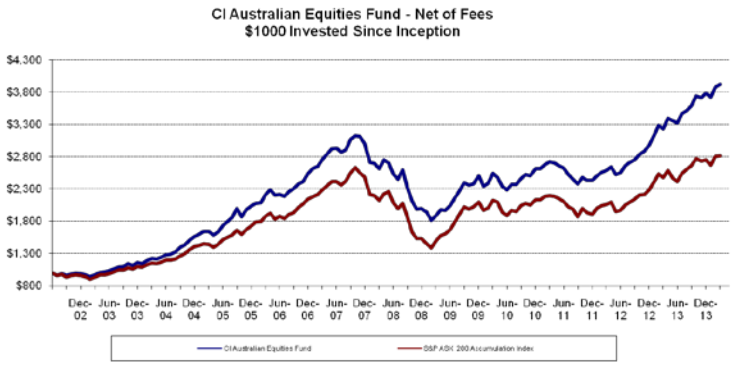
MARCH 2014

"Suckers think that you cure greed with money, addiction with substances, expert problems with experts, banking with bankers, economics with economists, and debt crises with debt spending." Nassim Nicholas Taleb, The Bed of Procrustes: Philosophical and Practical Aphorisms.

"The past is an educational toy for the present. It should be discarded the moment its usefulness is outgrown." Tom Morrison.

	**PORTFOLIO	#BENCHMARK	VALUE ADDED
ROLLING 3 MONTH	3.97%	2.09%	1.88%
ROLLING 1 YEAR	22.99%	13.46%	9.53%
ROLLING 3 YEAR	14.00%	8.54%	5.46%
ROLLING 5 YEAR	16.75%	13.39%	3.36%
ROLLING 7 YEAR	6.13%	2.98%	3.15%
ROLLING 10 YEAR	13.53%	9.37%	4.16%
SINCE INCEPTION*	13.51%	9.20%	4.31%
SINCE INCEPTION^	342.81%	181.13%	161.68%

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



Market and Portfolio Performance

The Benchmark rose by 2.09% over the quarter. This makes the third consecutive quarterly rise for the market, which has now gained 16.35% since 30 June 2013. The portfolio returned 3.97% over the quarter.

Strong portfolio performers over the quarter included TPG, Fletcher Building and Recall. Conversely, the upcoming ASX de-listing of FOX hurt the stock's performance, while Transpacific and Telstra were also both down slightly.

The half year earnings reports came in much as anticipated. There is still no real evidence of a substantive pick up in organic revenue growth across the market and cost cutting again came to the fore. Dividends rose across the market in line with hopes and expectations, and pay outs continue to be high on the list of investor demands. Residential building activity has clearly picked up in some states (NSW in particular) but remains biased towards multi dwelling, retail sales have at least stabilized as has consumer confidence. But there is still no unambiguous pickup in activity which can completely offset the ongoing fall in mining spend. With the Federal Government talking tough on budget issues, large doses of public sector stimulus look unlikely. We expect the current "grind it out" economic environment in Australia to continue for a while.

We did not participate in the rash of the recent listings dating back to the end of 2013, as generally they did not meet our investment criteria. We are however encouraged to see potential upcoming opportunities in the possible re-listing of Healthscope, and the longer dated float of Medibank Private announced during the quarter.

MARCH 2014

The Portfolio

During the quarter we participated in a private equity sell down and concurrent capital raising by **Energy Developments (ENE).** ENE has had a fairly colourful history – in the early 2000's it was a "market darling" and considered a potential leader in alternative waste and energy technology. The company was unable to live up to its promise and failed to deliver to expectations, predominantly around the significant budget blow-out on their West Kimberley Project (budget $180m vs final cost $320m) and complete write-down of their investment in the SWERF alternative waste treatment facility ($160m).

Pacific Equity Partners (PEP) made a takeover offer for ENE during 2009 and subsequently gained control. As PEP did not manage to get to 90% and a compulsory acquisition, ENE remained listed. Under PEP, management has increased the focus and improved the operating performance of ENE. While ENE has done a lot of heavy lifting under PEP ownership, it still has plenty of opportunities for further improvement. Key points behind our investment thesis include:

- ***Long duration and relatively predictable cash flows*** – ENE's asset base primarily consists of long duration energy generation infrastructure. In Remote Energy (~1/3rd EBITDA) the weighted average contracted period is to 2022 and in Clean Energy (~2/3rd EBITDA) the weighted average contracted period is to 2026. Over 80% of revenues are at fixed prices including 54% of capacity charge / take or pay revenues.

- ***Diversified asset base*** – ENE has a portfolio of 76 projects which reduces the reliance on any single asset.

- ***Growth options*** – ENE has a strong history of growth. It has grown its installed capacity by a CAGR of 17% over the past 25 years. Over the past 5 years it has expanded capacity by 264MW and the company is confident that it has a robust pipeline of further opportunities.

- ***Offshore earnings*** - ~25-30% of ENE's earnings are derived from the US and UK so it will experience a positive benefit if the AUD declines further.

- ***Solid balance sheet and good cash flow*** – net debt / EBITDA has been reduced to 2.5x following the recent capital raising – we consider this to be acceptable given the predictable nature of the cash flows. ENE produces strong equity free cash flow as the stay in business capital expenditure is relatively low given the sunk nature of its asset base – this allows ENE to either self-fund growth options or return capital to shareholders via fully franked dividends.

- ***Strong and well incentivised management team*** – Greg Pritchard (CEO) has done a great job re-focusing the business over the past few years. The company has moved away from being a technology innovator and now only invests in proven technologies. Additionally, all projects over the past 4-5 years have been delivered on-time and on-budget. Mr. Pritchard's equity options provide him with a strong incentive to continue to create shareholder wealth.

- ***Alignment of interests with PEP*** – PEP plans to undertake a staged sell-down of ENE. It currently still owns 69% - we take some comfort from having our interests aligned with the private equity investors.

- ***Reasonable valuation*** – at ~7x FY14 EBITDA ENE is trading at a substantial discount to other listed infrastructure peers (as well as the broader market) that range from 12-18x. While we do not expect this gap to close completely as we consider the cash flows to be slightly lower quality than those produced by airports and toll roads, we believe that there is potential for a multiple re-rate as ENE continues to deliver to plan in addition to some earnings uplift from growth projects. ENE is currently trading on a 4.3% fully franked yield and we believe there is the strong potential to increase dividends over time.

The key risks to our investment include a change to the current green energy policies (particularly the renewable energy target (RET)) and the closure of mines to which ENE has exposure. Our base case around the review of the RET is that the Government will not seek to substantially impact the economics of existing green energy investments that have been made in good faith, but will attempt to reduce the burden of further investment required to meet the current target. We believe that ENE's primary exposures are to tier 1 / lowest cost quartile mines and thus the risk of closure is low.

During the quarter we sold our stake in **Orora (ORA).** ORA is the Australian fibre/glass/can packaging business spun out of Amcor at the end of 2013. It is a much smaller company than Amcor and so we were left with only a small position in the portfolio. We decided not to build on this position and to put the money to work elsewhere due to our belief that:

- ORA has very low organic growth opportunities and, due to the fact that it is for the most part in duopoly industry structures in Australia, domestic bolt on acquisitions are likely to be difficult to achieve.

- Earnings growth is reliant on cost cutting and, in particular, on $50m of benefits arising from the recent investment in a new mill at Botany. While we are confident the first 70% of these benefits will come to pass, the balance rely at least in part on customer acquiescence and are in our view much less certain.

- The stock looks reasonably fully valued in light of the points above.

- We believe we have superior alternative investment options for the portfolio.

We took an initial position in **NAB** during the quarter. We continue to work on the thesis but initially we are attracted to the following:

- Overdue management change is finally happening at the company. As we write this note the CEO has announced his retirement (to be succeeded by Andrew Thorburn who has been running the New Zealand operations for the bank), new CFO Craig Drummond took his place at the end of 2013 (we believe he will be a very positive force within the bank), a new CEO of the wealth division has been appointed, while the chairmanship will likely change over the next twelve months.

- The stock trades at a discount to the sector and with a higher yield.

- The company has slightly above sector EPS growth due to cost out opportunities in the UK and Australia, as well as falling bad and doubtful debt provisions, particularly in the UK.

- Trends in UK banking and commercial real estate values in the UK are both looking positive for NAB.

- The sale of both the US bank and the UK assets is looking more of a possibility than it has been for the last few years. Any such action would be well received by the market.

- NAB's return on equity ranks as the lowest of its peers at 14.5%. However the sale of non-core assets as per the above would show an Australian bank ROE of 17.4%, second only to the CBA, and would justify a re-rating of the stock.

Stock News

As mentioned above, **Twenty-First Century Fox (FOX)** will delist in Australia and remain listed only on the NASDAQ in the US with effect from early May 2014. The effect of the announcement made at the end of last year has been for the stock to under-perform in anticipation of selling by Australian institutions. In our view the reasons for holding FOX, enunciated in prior quarterlies, have not changed and we remain attracted to the stock for its growth prospects, management capabilities and the ongoing buy back utilising balance sheet latency. Therefore, despite the change in listing, we intend to hold the stock as a US listed entity post its delisting in Australia.

Transurban (TCL) continues to progress its growth opportunities announcing:

- It has acquired the Cross City tunnel in Sydney for $475m. TCL had previously acquired the debt in the tunnel from Royal Bank of Scotland for the same amount. The tunnel runs into the Eastern Distributor in Sydney, also owned by TCL. The tunnel reportedly cost $1B to construct.

- It awarded the tender to build the 9km $2.65B North Connex tunnel to a joint venture between Lend Lease and Bouygues. This freeway links the M1 and M2 freeways in Sydney. It is anticipated that construction will commence in 2015.

Both of these initiatives will help to continue TCL's distribution growth beyond 2015/6.

Late in the quarter **Recall (REC)** announced a new ten year contract with HSBC to provide document and digital information and data protection services across ten countries. Although small in the overall Recall numbers (totalling 2% of revenue) we are pleased to see the news as it shows:

- renewed management focus back on the business;

- that the opportunity set for Recall remains large and global in nature; and

- that Recall is able to compete in the digital arena.

In February, **Oil Search (OSH)** raised $1.2bn in new equity through a placement of 10% of its shares to the PNG Government at $8.20 per share, a small discount to the prevailing share price. In a complex transaction, the Government was funded via a loan from UBS who in turn established a hedge position by selling $700m OSH shares. The CI portfolios were able to take up our pro-rata share of this $700m in equity, minimising the dilution impact of the placement.

The funds raised were primarily used to acquire a 23% gross interest in the Elk/Antelope gas discovery in PNG. Elk/Antelope is the largest undeveloped gas resource in PNG and it has the potential to support a two train LNG development. The operator of the field, Interoil, has recently announced a deal with the global LNG player Total to develop the resource as a standalone LNG project. However, with a strong JV position and the backing of the PNG Government, we would expect to see OSH push to integrate this resource into the Exxon Mobil operated PNG LNG Project to realise capital efficiencies and to ensure development of Elk/Antelope in the earliest timeframe. Today, OSH has a 29% interest in a two train LNG project about to begin production. By the end of the decade, we can see a pathway for OSH to have a c.25% share in five producing LNG trains in PNG, a growth profile which is still not fully reflected in the current share price.

International Trips and Market Observations

During March we visited **China** on our annual commodities-focused research trip. We have been significantly under-weight the resources sector (currently ~10%) for the past few years on the expectation of declining commodity prices and lack of returns on offer in the sector given the risks at this stage of the commodities cycle. In short, the trip did nothing to change this view, and, if anything, we came away more bearish on the outlook for Australian resources stocks.

There is little doubt that a large part of China's phenomenal growth over the past two decades has been fuelled by credit, particularly in the property, steel, aluminium and cement industries, which have continued to operate with large overcapacities. These overcapacities are mostly the result of loose credit and fixed asset investment stimulus policies of the previous Chinese leadership as they sought to maintain high-single to low-double digit GDP growth rates. This has been a boon for bulk and industrial metals demand and pricing, the most prominent example being iron ore.

Insights and conversations during this trip lead us to believe that, under the current leadership of Xi Jinping, this Chinese government is more focused on reducing over-capacities across industries, is less likely to stimulate fixed asset investment demand and is determined to reform the economy from investment-led to consumption-led. Previous governments have talked about cutting over-capacity and reforming the economy but it appears in hindsight to have been rhetoric. However, under this leadership the evidence indicates that the talk is leading to action. Certain industries have been added to a 'blacklist' that reduces their ability to secure financing through traditional banking channels, steel mills which aren't adhering to new stricter environmental requirements are finding that their water and electricity rates have increased significantly and local governments are working with certain steel mills to find alternative employment for their workers when they shut down. Xi Jinping is the most powerful leader in China since the 1980's and he appears determined to reform the economy.

These actions have led to a very slow first quarter of the year in China. 2014 has not yet seen a rebound in activity or demand post the February Chinese New Year holidays (as has occurred in previous years) and it is highly likely that first quarter GDP growth will be well below the 7.5% target for 2014. Yet none of the people we spoke with are expecting the Government to substantially stimulate (in the manner we saw immediately post the GFC) the economy any time soon. If there is any economic stimulation, it is more likely to be directed towards consumption and services industries, not fixed asset investment as in the past. Although we believe that China will still grow strongly over the long-term, 2014-15 is likely to be a difficult period for the economy as it undergoes structural reform to lessen reliance on fixed asset investment and to reduce the amount of risk in the financial system.

With this backdrop, we are more concerned about the outlook for commodities demand growth than we were before the trip. There are discussions in China that residential housing construction has peaked (accounts for 40% of steel consumption) and that peak steel consumption will occur earlier (and at a lower level) than market expectations of late this decade or early next decade. Combined with a substantial increase in new iron ore supply from the low-cost majors over the next 18 months, we feel there is a risk of iron ore prices dropping below market expectations over the medium-term. With iron ore accounting for over 85% of Rio Tinto's earnings and over 50% of BHP Billiton's earnings, we believe that earnings are likely to remain under pressure for the major miners over the medium-term.

The trip also provided insights into the coal market, which impacts our holding in Aurizon (AZJ). The outlook for export coal markets supplying China has deteriorated over the past year, both in demand and pricing. China's domestic coal production continues to grow strongly and coal consumption growth is slowing (both thermal for power generation and coking for steel production). Some contacts suggest that China coal imports have peaked. If so, it is difficult to see much growth in medium-term coal exports from Australia. Fortunately, AZJ continues to have many opportunities to improve its operational and capital productivity that are not reliant on coal volume growth and as such it remains an attractive investment. But we continue to watch coal market developments very closely. We still believe that the most attractive investment opportunities in relation to China are in the consumption/services related sectors. Stocks in the portfolio that have small but rapidly growing exposures to these sectors include Sydney Airport, Auckland International Airport, Brambles and FOX.

Note – the Fund's holding in Twenty-First Century Fox

The Fund's holding in Twenty-First Century Fox, Inc ("FOX") will be de-listed from the Australian Securities Exchange on 1 May 2014 and become solely listed on the NASDAQ in the United States. FOX has been a strong contributor to the Fund's performance over the last three years and, as discussed earlier, our reasons for holding FOX remain unchanged. Pursuant to the Constitution of the Fund, the Fund may hold international securities and, given our investment view, we consider it in the Fund's best interests to continue to hold the position in FOX. We have taken the view that we will not hedge the currency risk. As Cooper Investors manages $1.1 billion in international equities we have the systems and dealing processes in place to manage a position listed in the United States.