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.

MARCH 2018

"It is not sufficient to see and to know the beauty of a work. We must feel and be affected by it." Voltaire

"Conventional wisdom leads to mediocrity." Sam Zell

"When hiring, if forced to choose between virtue and talent, choose virtue." Charles Koch

"No matter how dramatic the end result, good-to-great transformations never happen in one fell swoop. In building a great company, there is no single defining action, no grand program, no one killer innovation, no solitary lucky break, no miracle moment. Rather, the process resembles relentlessly pushing a giant, heavy flywheel, turn upon turn, building momentum until a point of breakthrough, and beyond" Jim Collins

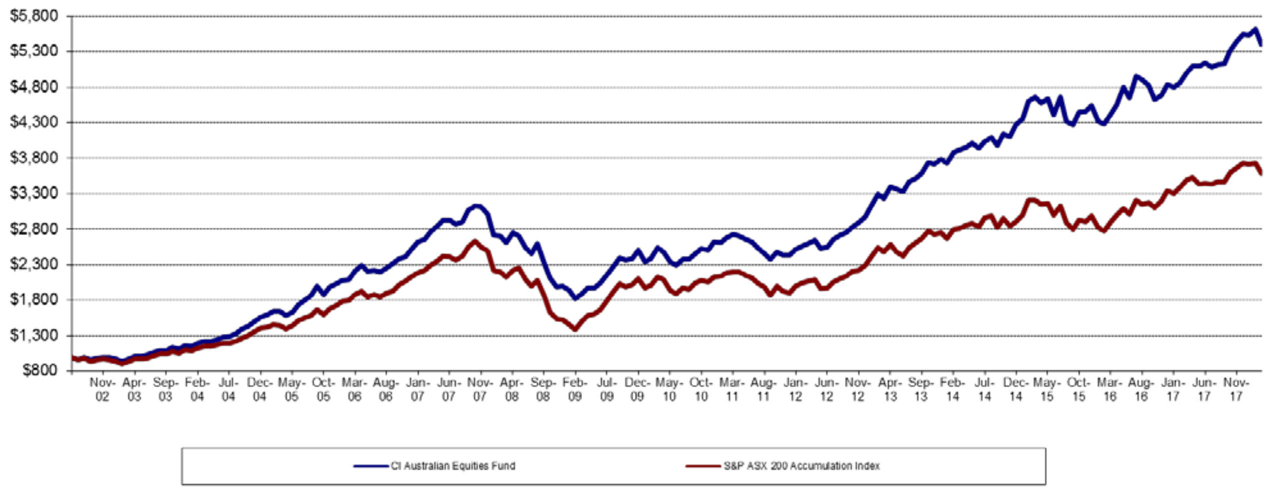
"The road to success and the road to failure are almost exactly the same." Colin R. Davis

"The successful warrior is the average man, with laser-like focus." Bruce Lee

	****PORTFOLIO**	**#BENCHMARK**	**VALUE ADDED**
ROLLING 3 MONTH	-2.43%	-3.86%	1.43%
ROLLING 1 YEAR	8.93%	2.54%	6.39%
ROLLING 3 YEAR	6.21%	3.76%	2.45%
ROLLING 5 YEAR	12.18%	7.66%	4.52%
ROLLING 7 YEAR	11.48%	7.23%	4.25%
ROLLING 10 YEAR	8.68%	5.35%	3.33%
SINCE INCEPTION*	12.51%	8.45%	4.06%
SINCE INCEPTION^	539.65%	258.41%	281.24%

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

CI Australian Equities Fund - Net of Fees
$1000 Invested Since Inception



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

For current performance information please refer to the Monthly Performance Report.

MARCH 2018

Market and Portfolio Performance

The March quarter of 2018 was difficult for both domestic and global equities markets. In response to concerns that a global trade war could erupt following US government proposals to introduce tariffs on steel and aluminium imports, the ASX 200 Accumulation Index fell 3.9%, with most of the fall occurring in the month of March.

A tit for tat escalation of tariffs remains a possibility, which could create further volatility in financial markets in the near term. The seriousness of US intentions shouldn't be underestimated given the tariffs come not long after a significant tax cut (ideally you would stimulate prior to a trade war). The key risk for equities markets is collateral damage, as stated via an old African proverb – *"when elephants fight, it is the grass that suffers"*.

During the quarter contributors to performance included **CSL (CSL)** (strong first half result), **Iluka (ILU)** (ongoing strength in mineral sands prices) and **Macquarie Bank (MQG)**.

Portfolio stocks performing poorly included **Qube (QUB)** (flat first half result and market perception of slower than anticipated lease take up at Moorebank), **Sims Metal (SGM)** (caught up in the tariff dispute) and **Transurban (TCL)** (impact of rising bond yields).

Stock News

Wesfarmers' (WES) new CEO, Rob Scott has embarked on a transformational transaction with the de-merger of the Coles supermarket business. The de-merger of Coles will be the culmination of a period of significant change for Wesfarmers. Rob Scott officially began in the role in November 2017, along with a new CFO, and the previous year saw new heads of both the Bunnings and Industrials divisions, as well as a new head of Business Development. On top of this WES has successfully sold the Curragh coal mine, with a 40% stake in Bengalla their only remaining coal asset.

This last period has not been without its difficulties. In particular the still relatively recent move into the UK hardware retailing market has been poorly executed, and resulted in the business being substantially written off after losing $165m EBIT in the first half of FY2018. This is a major disappointment and remains a significant issue for the new executive team to resolve.

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. The business will also be more focussed on Bunnings Australia (approx. 50% of EBIT), a business with a strong franchise that continues to have options to extend and expand their offering.

We see substantial latency existing in the Wesfarmers business that is not reflected in the current market price for the company. It is encouraging that new management are of a more active bent than that which we saw previously. Combined with effective execution, we would anticipate this delivers stronger returns for investors.

In March **Transurban (TCL)** announced that it had agreed to acquire the A25 toll road and bridge in Montreal (Canada) for CAD $858m, which equates to an implied EV/EBITDA multiple of 26x. The A25 was acquired from Macquarie Infrastructure Partners, an unlisted 10-year closed-end fund that is in the process of liquidating assets, in what we understand was a competitive bidding process. The transaction will be funded from existing balance sheet capacity and management expect the acquisition will be immediately accretive to TCL's distribution per security. Financial close is targeted for Q4FY18 and is dependent on Investment Canada Act approval.

The acquisition marks the entry into a new market that TCL views as attractive given Montreal is a heavily congested urban area with strong demographics. TCL had previously identified Montreal as a North American market with network potential so the acquisition is consistent with strategy. While the headline transaction multiple of 26x appears full, particularly in light of the remaining 25 year concession life, we assume future network potential featured into TCL's assessment of the deal. As usual, we expect TCL will drive further value from a combination of optimising operations, debt refinancing, road expansions, and proposing new network enhancements.

The Portfolio

We added **Lendlease (LLC)** to the portfolio. LLC is a vertically integrated property and infrastructure group with operations in Australia, Asia, Europe and the Americas. LLC's business segments span Development, Construction and Investments covering a diverse range of businesses including apartments, house and land development, commercial property, retirement living, and US military housing amongst others.

We like LLC's exposure to global trends such as urbanisation, infrastructure and construction spending, funds management, and the ageing population. These trends underpin a global pipeline of projects that provide LLC with good earnings visibility in coming years. The current development pipeline of $57b, including over $40b of urbanisation projects, supports almost a decade of work which management believe have been originated at strong embedded margins.

LLC also has a significant opportunity over the medium term to grow its funds management platform from the current $28b of FUM. There is approximately $4b of secured additional FUM from development projects currently in delivery, £1.5b (A$2.8b) of committed UK build-to-rent product, and a further targeted US$5b (A$6.5b) from US telco infrastructure assets. This provides a clear pathway to over $40b of FUM, and this doesn't include any additional FUM from the secured development pipeline that is yet to enter delivery.

Importantly, for a cyclical business, the balance sheet is strong with 3.8% gearing and total available liquidity of $3.9b, which provides LLC with further latency. The stock is trading on a PER of 13.3x which is not expensive, and is delivering a 13.8% ROE and 3.8% dividend yield. We think the management team under CEO Steve McCann have demonstrated a strong focus on capital allocation and have positioned LLC well for the future.

Orica (ORI) was added to the portfolio over the last quarter. Orica has maintained a strong position in the industry, with latent capacity on the Australian East Coast that will capture the majority of the growth in explosives demand in that market. This will see utilisation and margins gradually improve as growth returns. On this front, industry demand and pricing for Orica's products appears to have bottomed. Although we do not anticipate a return to the boom times seen earlier this decade, a moderate growth environment looks likely, supported by resilient commodity prices and end market demand.

Additionally, the focus of the larger miners is shifting from cost cutting to productivity improvement. ORI should benefit from this trend due to the significant investment in R&D that they have undertaken over many years. This investment in technology and expertise can be brought to bear to improve end-to-end mine process productivity, and puts Orica in a stronger competitive position relative to less advanced operators.

After a period of underperformance within the company, current CEO Alberto Calderon has worked hard to both improve returns and fix a culture in a business that was struggling against industry headwinds. Although he has made good progress and built an experienced team around him, recent fatalities in the business highlight that there is still work to be done.

For current performance information please refer to the Monthly Performance Report.

MARCH 2018

During the quarter we sold our in **Aurizon (AZJ)**. AZJ has been a portfolio holding since IPO in 2010 and has been a positive contributor over the period, albeit underperforming since QCA's draft announcement on UT5 late last year. As we discussed in the last quarterly, we believe the QCA has assumed an aggressively low cost of capital along with a low operating and maintenance cost recovery. As an investor, particularly in infrastructure assets, we look for a stable and consistent regulatory framework. We recognise that interest rates have trended down due to unconventional monetary policy and the effect it has had on asset returns, but we find it difficult to accept a sub 5.5% return over the next 4 year regulatory period on a coal network asset that is not riskless. The inputs into the WACC such as the risk-free rate and debt risk premium were effectively set at the low point in 2017 with the risk-free rate increasing since. The QCA follows a rigid process in setting the WACC and it is difficult to see them change their stance. We commend the management team's efforts on further improving productivity and restructuring the intermodal and bulk businesses which should deliver a positive outcome over the medium term. The reality is that if the QCA final outcome is similar to the draft outcome, it will largely offset management's initiatives and the improving coal volume in the above rail business. Given this and the reduced valuation upside, we decided to allocate the capital elsewhere.

Industry Observations

There are some signs that inflation is no longer dormant, particularly in the USA. Arising both naturally from a busier economy and fuller employment, as well as via regulatory actions, some more recent observations around supply chain costs include:

- Higher lumber costs in the US, partly as a result of tariffs imposed on Canadian imports;
- Higher transport costs in the US as a result of a shortage of driver capacity – both demographics (millennials do not want to be truck drivers) and regulation imposing stricter limits on driver welfare (limiting amount of time at the wheel, drug testing etc);
- Higher resin prices resulting from both hurricanes disrupting capacity, but also a shortage of capacity as a lack of recent new investment is now being felt as global economies growth improves;
- Increase in the effective minimum wage in the UK from £7.70 to £9.00 over the next few years;
- Wage pressures in China;
- Resource companies seeing increasing wage costs and input costs (eg diesel, contractor costs).

Although equities are generally considered an inflation hedge, large, sharp increases in inflation can be problematic for equities. An extreme example from history is illustrative – when inflation rose in the US from 3% to 12% starting 1973 (Oil prices quadrupled), the S&P500 fell 48% and many high quality stocks performed poorly (Coca-Cola -60%, Johnson & Johnson -40%, Disney -80%).

We remain of the view there will be both winners and losers should some of these 'macro' forces play out and that our best defence against market volatility is our VoF process that has proven resilient through various market cycles. However there are few if any signs of these input pressures showing up in the official inflation statistics – pressures at the retail/consumer end of the supply chain are so far sufficiently strong to stop more widespread price increases. As long as these forces persist then we are unlikely to see a more serious break out in inflation.

Trip Notes

During March we travelled to the UK to attend the **Brambles (BXB)** investor day. For context, BXB is the global leader in pallet pooling and 'moves more goods to more people in more countries than anyone else on earth'. Interestingly, despite this fact, its network (390m pallets/ crates/ containers, 60 countries, 850 service centres), which has been built over 40+ years, has not yet fully penetrated its potential markets. We reduced our position in the stock some 12 months ago at which time Tom Gorman the prior CEO of BXB had just resigned (and sold all his shares), with a series of profit downgrades to follow relating to challenges in its US business, and a reassessment of long-term return on capital targets.

Since that time, new CEO Graeme Chipchase and new CFO Nessa O'Sulliavn have steadied the ship. Although we expect some near-term headwinds from rising costs (particularly in the US), our VoF proposition for BXB includes:

- ongoing revenue growth from increased penetration in pallets and reusable plastic crates (RPCs);
- margin uplift in the US from cost out, procurement initiatives, automation, surcharge and capex initiatives;
- improved cash flow (improvement in cycle times, loss rates, damage rates, pallet costs); and
- over the longer-term, potential benefits from both digital initiatives (track and trace sensors on pallets should reduce lost pallets and lock in customers) and optionality in China becoming a viable pooling market.

We spent a week in China in mid-March, visiting Beijing, Tangshan, Jinan and Shanghai. It was an interesting time given the constitutional change to abolish the term limits on Xi's presidency, which will give him time to continue to push through the party's reform agenda. The strong focus on improving the environment and supply side reform remains. The steel capacity cuts in northern China were enforced which reduced output but were offset to an extent by increasing usage of scrap and high grade ore by operating mills. Steel mills, in particular private mills, are likely to change their mix of raw material inputs depending on steel margins in the short-term but the industry trend towards higher grade ores is still playing out.

The key change from our trip in October last year is that credit is tighter. The government is aiming to reduce financial risk and in particular curb the shadow banking sector. This has flowed down to the broader economy and anecdotally has resulted in stricter lending criteria and higher interest rates to the traders we met. There has also been a delay in the demand recovery post the Chinese New Year festive period due to the two national party meetings that were held in March. Although conditions remain tighter, the government still remains supportive of infrastructure investment. In the property sector, lending conditions will remain tight in tier 1-2 cities where price growth has been strong while tier 3-4 cities are likely to continue to benefit from the government's shanty house redevelopment policy.

Our views remain largely unchanged post our trip. We recognise commodities last year were broadly supported by both supply side reform and better demand conditions. Supply side reform will continue although the impact will be less meaningful compared to the last couple of years with significant excess capacity already removed across a number of industries. However we remain of the view that capacity will remain tight which will lead to higher profitability over the medium term across steel, aluminium and mineral sands.

We were also in the US in March and came away with a clear sense of a robust economy and high levels of activity, with some sectors beginning to come up against constraints, particularly in the labour and transport markets.

The construction markets are robust, with ongoing investment growth in the private sector, both residential and non-residential, providing a positive industry environment for Boral in particular, but also for BlueScope's US operations. A consistent message from industry participants was that although demand was not as strong as prior to the previous recession, the visibility in the outlook was greater than they had ever seen.

Public sector investment has so far lagged the private sector in this cycle. The potential for a step change in public sector capex from President Trump's federal infrastructure plan was seen as a potential longer term positive, but will not hit the ground for 2-3 years, with much of the detail yet to be determined. It would appear that the plan will require private sector involvement in PPP style investments, potentially opening up additional opportunities for both Macquarie and Lend Lease in the US market.

Additionally, we took some time in the US exploring technology in the grocery retailing industry. What became evident was that, relative to the US, the major Australian industry participants are well advanced in their thinking and the integration of data analytics, automation and on-line capability. In fact, some of what we see from Woolworths in the domestic market may be considered cutting edge and leaves the company well positioned to withstand the competitive threats that they face longer term.

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.

MARCH 2018