# CI AUSTRALIAN EQUITIES FUND
# QUARTERLY REPORT

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

## SEPTEMBER 2013

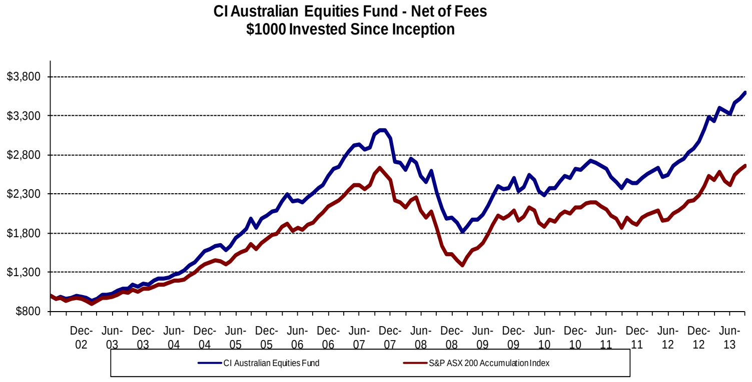
***"We find that whole communities suddenly fix their minds upon one object, and go mad in its pursuit; that millions of people become simultaneously impressed with one delusion, and run after it, till their attention is caught by some new folly more captivating than the first." "Extraordinary Popular Delusions and the Madness of Crowds", Charles Mackay, 1841.***

***"Formula for success: rise early, work hard, strike oil." J. Paul Getty.***

***"The pessimist complains about the wind; the optimist expects it to change; the realist adjusts the sails." William Arthur Ward***.

| | **PORTFOLIO | BENCHMARK | VALUE ADDED |
|---|---|---|---|
| ROLLING 3 MONTH | 8.25% | 10.20% | -1.95% |
| ROLLING 1 YEAR | 31.94% | 24.29% | 7.65% |
| ROLLING 3 YEAR | 14.41% | 9.28% | 5.13% |
| ROLLING 5 YEAR | 10.07% | 7.30% | 2.77% |
| ROLLING 7 YEAR | 7.51% | 4.70% | 2.81% |
| ROLLING 10 YEAR | 13.78% | 9.82% | 3.96% |
| SINCE INCEPTION* | 13.20% | 9.10% | 4.10% |
| SINCE INCEPTION^ | 302.98% | 166.27% | 136.71% |

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




## Market and Portfolio Performance

The Benchmark rose by 10.20% over the quarter. The portfolio returned 8.25% over the quarter. During the period, positive contributors to performance included Transpacific, Fletcher Building, Macquarie Group and Sydney Airport. Conversely, a negative earnings surprise hurt the performance of QBE, and rising interest rates affected the performance of GPT. Amcor rose slightly but under-performed the broader market, while the share price of both Brambles and Tatts Group fell slightly.

The fiscal 2013 earnings results season did not yield many shocks – not surprising in light of continuous disclosure requirements – but again led to slight earnings downgrades for the forthcoming year. Dividends as a whole rose this last year and we would expect another small rise next year. However the tailwind of falling interest rates has subsided and companies will need to pursue even more cost out initiatives, and find revenue growth, to keep earnings moving up next year. Current market forecasts are looking for 13% eps growth in 2014 and 4.5% in 2015, placing the market on a p/e of 14.9X for 2014 and 14.2X 2015. This aggregate number disguises very different sub-sector forecasts – with resources rate of growth at 25% in 2014 expected to be roughly double that of the industrial ex financials sectors. Banks growth is forecast in low single digits. Interestingly, revenue growth is forecast to be circa 7% for the industrials, implying little to no cost and interest leverage. We can't help but think, as we sit here today with unemployment creeping upwards, and as yet no sign of a consumer retail recovery, that another low growth year is likely. However the election is now behind us, interest rates are low, and housing and equities prices are rising, all of which are positive indicators for consumer behaviour.

## The Portfolio

During the quarter we purchased shares in **Sky Network Television (SKT)** and currently hold approximately 5.6% of the company. SKT is New Zealand's sole pay TV provider, delivering content to approximately 50% of the population via satellite and over the internet. The recent decline in SKT's share price afforded us an opportunity to acquire the shares for substantially below our assessment of intrinsic value. The key tenets of our investment thesis are as follows.

- Solid earnings growth outlook over the medium-term driven by recurring subscription-based revenues and the willingness of existing customers to increase spend on content.
- Highly cash generative business with a history of paying out all free cash flow to shareholders through ordinary and (somewhat recurring) special dividends.
- Good balance sheet latency (under-levered compared with global pay TV peers) affording management optionality to pursue value accretive opportunities and sufficient fire power to keep competitors at bay.
- Very strong competitive position with high barriers to entry given the weak free-to-air TV stations (especially compared with Australia) and significant incumbent advantages.
- Low technology and capex risk from being a "fast follower" in pay TV technology.
- Positive industry trends of increasing demand for premium and on-demand/time-shifted content (as spoken about in previous quarterly reports in relation to News Corp).
- Long-serving quality management team that act like owners and have a strong track-record of tight cost control (especially programming costs, the largest cost of Pay TV operators).

During the time that we were accumulating the position, SKT's share price was under pressure due to a range of factors, including lack of subscriber growth, increasing competition driven by internet delivery of content and regulatory risks. Whilst all are valid concerns, we believe that these risks are overstated by the market. We expect subscriber growth to improve with more focus on "triple-play" (broadband, fixed-line telephone and pay TV) packages from resellers of SKT product. We view the internet as an enabler of SKT's products which will outweigh any negatives from increased competition. With the loss of some recent content rights (reducing market dominance), and the extension of a reseller agreement, we believe regulatory risks are subsiding (although we continue to watch closely).

During the quarter we participated in the **Z Energy** IPO and subsequently increased our position by buying additional shares on-market. Z Energy is the former Shell NZ fuel distribution business which was purchased by Infratil and the NZ Superannuation Fund in early 2010. We are attracted to Z Energy for the following reasons.

- <u>Quasi public to private turnaround</u> - Generally, we are very attracted to public to private turnaround stories – we find that the operations tend to have significant latency and there is a large energy release. Z Energy has many similar attributes to such a situation given the downstream Shell NZ assets would have been a speck in the ocean relative to Shell's global opportunity set resulting in them being neglected and under-invested. Z is now a nimble locally owned company competing against slow moving global multi-national oil companies.
- <u>Attractive market structure</u> -The 4 incumbent operators essentially own the entire downstream infrastructure (e.g. terminals, pipelines, coastal ships etc.) in NZ (with the exception of Gull who own 1 terminal at Mt Maunganui). New entrant economics are not attractive given that it is very difficult to get the required scale in most regions due to the dispersed population and remote geographies. This enables the incumbents to ensure that the fuel margin is captured at the primary distribution level rather than the secondary distribution / retail level.

- Quality management team - Z has a high quality executive team who have considerable industry experience.

- Incremental organic growth opportunities - While several initiatives have been implemented over the past couple of years (e.g. the store re-branding and reinvigorated retail offer) there remain several other organic opportunities over the coming years such as opening new retail sites, improving product procurement and refinery / coastal shipping optimisation.

- Industry consolidation - There is a strong possibility for a game changing acquisition of one of the other incumbent operators in NZ – there would be significant synergies from such a transaction both from an operating cost perspective and a working capital perspective.

- Un-demanding valuation - At the IPO price of NZ$3.50, Z was on an EV/EBITDA of ~8x, PE of 13x and cash dividend yield of ~6%. These metrics are attractive for a business with a very favourable market structure, infrastructure type characteristics and a runway of growth opportunities (both organic and acquisitive).

We also established a position in **Auckland Airport (AIA)** during the quarter. While there was no specific news flow around AIA, recent results have confirmed the underlying positive trends of the business and the new CEO brings a lot of energy to the role. Our investment proposition is as follows.

- Long duration strategic asset - AIA own the airport site and adjoining 1,500 hectares of land freehold. The airport is located 20km from the Auckland CBD and 74% of all international arrivals into NZ are via AIA. Additionally, the company owns ~25% of Queenstown, Cairns and Mackay airports. This strategic value was recognised by a Canadian pension fund who offered $3.65 for AIA in 2007. We believe many “equity” investors fail to fully appreciate the long duration growing nature of the cash flows generated by airports and the ability to fund growth with debt while still maintaining a strong balance sheet.

- Benign regulatory environment - The recent findings from the Commerce Commission’s report on AIA found that it is not extracting excessive profits and the regime is promoting innovation and provides a quality service. The current aeronautical pricing regime is locked in until FY17. Given the small cost of aeronautical charges (domestic $5.55 and international $21.55) against the price of an airfare it is not a politically “hot” issue / vote winner.

- Revenue diversity - AIA, like its Australian peers, has a well diversified revenue base. We believe the revenue mix of AIA is very attractive:

  - 44% aeronautical revenue: provides low risk growing WACC type returns. Given the strong demand growth for travel, there should be the requirement for continued expansion and capacity upgrades, which ensures this will continue to grow.

  - 28% retail revenue: provides exposure to one of the most attractive retail assets in the world with a highly captive market.

  - 13% commercial property: AIA are creating commercial and office precincts on their significant land bank which they will be able to continue to develop for the next 20+ years.

  - 9% car park: currently have 6,500 short and long-term car parks with plenty of opportunity to continue to expand.

- Low risk exposure to the Asian consumer story - Inbound arrivals from Asia, and particularly China, are growing extremely strongly. Chinese passengers have grown from 34k in 2000 to 197k in 2012. We believe this is a structural growth story and will continue relatively unabated for the next several years. Given the high importance of international passengers to AIA’s overall growth (higher aeronautical charges and significantly higher retail spend), this should provide strong support to overall airport growth.

- History of profitable growth - AIA has grown EBITDA from $124m in 2000 to $329m in 2013 (CAGR of 8%) at incremental returns on capital expenditure of close to 20%. We believe that AIA should be able to continue to grow in the mid-to-high single digits range for the foreseeable future.

- Fair valuation with latency - We purchased AIA at fair value with upside latency from:

  - Faster growth: our base case assumptions are relatively conservative. If AIA is able to achieve EBITDA growth 1% ahead of our assumptions over our forecast period, our valuation would increase by 10%.

  - Balance sheet: AIA has an extremely strong balance sheet – we believe AIA could return ~$700-800m to shareholders (~16-18% of the current market cap) and still have a credit rating of at least as good as SYD.

  - Land bank: AIA's 1,500 hectares of land only 20km from the Auckland CBD is highly strategic and will only increase in value over time.

During the quarter we bought a small position in **TPG**. TPG was founded by its current CEO, David Teoh, in 1986 (formerly SP Telemedia). It initially sold internet related services and computer equipment. The company listed on the ASX in May 2001 and it has grown organically and through acquisitions to become a major player in the Australian telecommunications industry. The business has a strong network presence, established through its strategic investment in DSLAM infrastructure (commenced in 2005) and its acquisition of Pipe Networks (in 2010) for $373m. TPG's consumer division provides broadband, voice and mobile services nationwide. The business is Australia's 4th largest and fastest growing ISP with 630k broadband subscribers (~11% market share) and 300k mobile subscribers, supported by a large exchange presence in 400+ DSLAMs and an extensive east-coast backhaul network. TPG's industry leading low cost business model has allowed the company to pursue an aggressive price-led broadband strategy.

As well as the stock purchases indicated above, we sold our position in **Rio Tinto** (RIO). In our March 2013 quarterly report we spoke about our optimism for a turnaround in RIO's fortunes under a new CEO and CFO. Whilst we believe that the company is trending in the right direction, we have become increasingly concerned about the company's balance sheet and the time taken to enact significant change. With a level of debt that the company admits is higher than they would like, we had hoped for more aggressive assets sales, a reduction in capex spend and/or a pause in dividend payments until the balance sheet has been restored.

In our view, RIO is now more-than-ever a leveraged play on the iron ore price given its level of debt and dependence on earnings from iron ore (approximately 90% of EBIT). Should iron ore prices hold around these levels for the next 1-2 years then the balance sheet issues subside and we were wrong to sell the stock. However, should iron ore prices retreat (currently $130/t, $90/t in September last year) as market consensus expects, then the balance sheet could become stressed and a substantial decline in the share price is likely. We don't like investment propositions such as this and we will continue to focus on investing in high quality companies with value latency that are not reliant on beneficial macro trends to justify current share prices.

With the sale of the RIO position we are further under-weight mining companies (approximately 10% under-weight), with our only holding an under-weight position in **BHP Billiton**. This weighting hasn't worked for us during this quarter with a jump in mining company share prices on China data beating expectations and the continuation of low interest rates globally supporting commodity prices. However, mining companies have been solid under-performers over the last 12 months and with an expectation of declining commodity prices over the medium-term, we still can't see sufficient value across the industry to warrant taking a more positive position.

We also sold our small position in **News Corp**, established when the split from Fox took place. We have kept our position in Fox for reasons we have enunciated in prior quarterly reports. News Corp, however, is a very different company. The future earnings and cash flows are not sufficiently transparent for us to remain on the register. The future for the print assets in the UK, Australia and the USA is unclear as management struggles to replace falling advertising revenue streams, to cut costs fast enough to keep pace with revenue degradation and to turn them into a profitable online venture. While Foxtel remains a strong asset, to grow subscriber penetration much further, one assumes the subscription price must drop. Real Estate.com appears to us to be expensive, trading on 17X EBITDA, and the new education business Amplify is losing $180m pa. The offsetting factor in all of this is the balance sheet, which contains $2.5B of cash – one wonders what Rupert Murdoch has in store for this pile of goodies!!

Finally, we sold out of our position in **APA** for the following reasons:

- Having previously indicated that the company would look to grow in the unregulated space, management is now bidding for a highly regulated set of assets.
- There is no obvious source of value add from acquiring Envestra and certainly the price offered by APA at 1.3X RAB is not a bargain basement price.
- As gas prices have risen on Australia's Eastern seaboard, and tougher economic conditions remain, so volumes have slowed. In light of further significant price rises being spoken about and evidenced in newly struck market contracts, we believe volumes will continue to struggle to grow rapidly.
- There is some competition emerging for pipeline capacity (e.g. AGL storage facility in Newcastle).
- The share price had appreciated substantially to the point where it was, in our view, no longer undervalued.

## Stock News

**Ramsay Healthcare** has been expanding in Australia (brownfield construction) and overseas (UK and France by acquisition) for some years, although overseas acquisitions have not been witnessed in the recent past. The company has now announced the completion of two overseas ventures. Ramsay has bought a 531 bed hospital in Toulouse, France which will give the company much more prestige and presence in the French market. It is likely to presage further acquisitions as prices appear of late to have become more affordable. In addition, the company finalised a joint venture with Sime Darby in Asia whereby Ramsay will contribute their Indonesian hospital assets as well as some cash and Sime Darby will contribute their Malaysian hospitals. The expectation is Ramsay will bring their operational expertise to bear while Sime Darby's local knowledge and connections will be used to expand the joint venture's presence in the region.

In July **QBE** provided an update on their Global Operational Transformation Program. The transformation program is expected to deliver annual run-rate benefits of at least US$250m by the end of FY15, with implementation and restructuring costs of US$310m that will be taken above the line. These projections exclude an estimated additional US$90m of run-rate savings from global claims procurement savings. The management presentation focused on the need to simplify and standardise processes across the business, noting that there is a bit of work to do to get up to global best practice. The key work streams are back office functions such as finance, HR, claims processing and management, IT and non-claims procurement. The transformation program was first rolled out to the Australian business in 2012, which we understand is already exceeding initial targets, with completion expected by 1Q14. Management plan to roll the program out to the North American business in 4Q13, which represents the biggest cost-out and efficiency opportunity, and to the European business in 2Q14.

Our sense is that there is plenty of scope for cost savings and efficiencies across the business, given that the previous management team ran the various business divisions as a series of independent 'silos'. As such, we expect that the cost savings targets should be exceeded, although given QBE's recent poor track record, we do not think the market will factor this in until there is some evidence that the targeted cost savings are being delivered.

Having witnessed the News Corp demerger, two more of our bigger holdings also announced demergers during the quarter. **Brambles** has decided to demerge its Recall document storage business, an unsurprising decision in light of management's unsuccessful attempt to sell the business last year. **Amcor**, in a more surprising move, advised the market that it would demerge its Asia Pacific business at the end of 2013. In both cases the demerger will allow greater focus on both businesses within each company, but will release the larger growth oriented parts of the respective companies (pallets and RPCs for Brambles and emerging market flexibles for Amcor) to be allocated capital without hindrance from the perceived lower growth or structurally less attractive assets. History indicates most demergers lead to stock price out-performance from the whole and we believe this will be the case for both these companies. The Recall business has a number of attractive attributes, and the Amcor Asia Pacific business will have cost benefits of circa $60m (arising from recent management restructuring initiatives) to kick in for the two years post demerger.

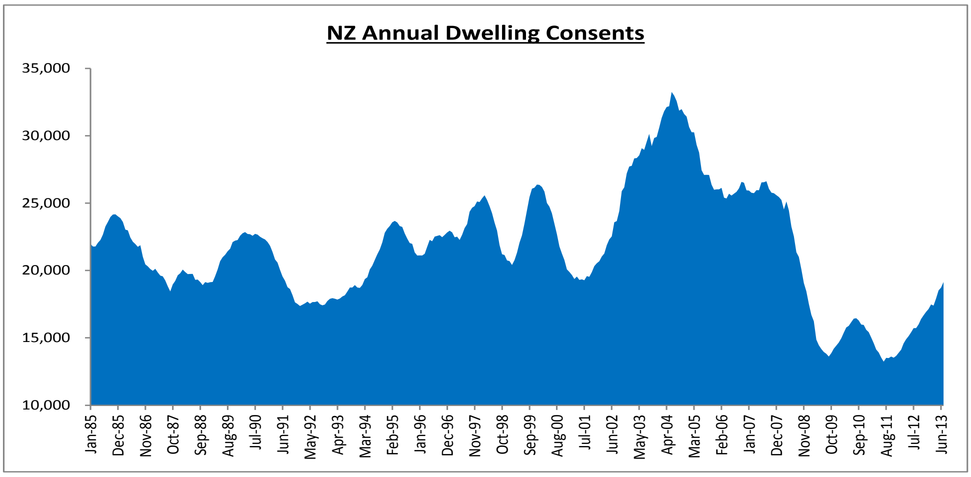
**TPG Telecom (TPM)** reported FY13 results in September. While the financial results were solid and highlighted the strong operational momentum within TPG's consumer broadband business, which added 76k subscribers, the most exciting aspect of the announcement was the unveiling of the Fibre-to-the-Building (FTTB) initiative. Under its FTTB strategy TPG plans to roll-out high speed (100Mbps), unlimited and low cost ($69/month) broadband to high rise buildings in major metro markets utilising its existing fibre infrastructure (a legacy of its Pipe Networks acquisition made in 2010). The target roll-out aims to pass 500k customer premises, of which around 10% are existing TPG customers. In a nutshell, the benefits of FTTB include more customers, lower cost to serve by bypassing the $16 ULL access charge and further entrenchment of TPG's infrastructure competitive advantage. The key risks around the initiative include the logistical challenges associated with a new large scale roll-out and potential left-field regulatory issues which may require negotiation along the way. Nonetheless we think TPG is well placed to manage through these challenges.

## International Trips and Market Observations

We did not travel during the quarter, but we will be doing so extensively to Europe and the US over the coming two months. As evidenced by the new portfolio positions outlined above, in addition to existing positions in Fletcher Building, Transpacific (who own the largest waste company in NZ) and Fisher& Paykel Healthcare, it is clear that we have increased our portfolio weight towards New Zealand in recent times. While all of these decisions have been driven by our fundamental bottom up VoF investment framework, it is worthwhile reflecting on why our incremental investment ideas in recent times have come from across the ditch.

We believe that NZ has some very favourable attributes, including:

- Housing recovery - Unlike Australia, NZ was severely impacted by the GFC. While not as widely publicised as the US housing correction, due to its relative small absolute size, NZ had a housing market correction of similar relative magnitude to the US. Housing starts collapsed from over 33,000 in 2004 to just over 13,000 during the GFC – a fall of over 60%. This was undoubtedly a painful experience for NZ at the time, but helped to rid the industry of speculative developers and shonky finance companies and resulted in a big efficiency drive by building materials companies. Housing consents are now growing strongly and we feel the recovery is equally or more sustainable than that currently taking place in the US, driven by some of the points outlined below.




*Source: NZ Statistics*

- Durable people and institutions - NZ is extremely geographically isolated – isolation tends to build character and durability. This character and durability is evident in some extremely strong and innovative institutions in NZ such as the biggest dairy exporter in the world (Fonterra), a world leading over-the-top accounting software provider (Xero), the only company in the developed world that has beaten eBay at its own game (TradeMe) and the best rugby union team in the world! While these traits were historically also evident in Australia, the free kick from the mining boom over the past decade has resulted in some complacency creeping in over recent times.

- Favourable market structures - The small, geographically isolated location and disperse population results in some fairly attractive market structures developing such as Fletcher Building's dominant market positions in plasterboard and cement or SkyTV's commanding position in pay TV. Examples of so-called "island economics" are also prevalent in Australia but tend to be more pronounced in NZ.

- Strong and nimble Government - NZ is on track to record a budget surplus in FY15 and has recently climbed 5 places in the World Economic Forum's annual global competitiveness index to 18$^{th}$ (the first time it has ever been ahead of Australia) – a highly enviable position. The RBNZ's recent restrictions on high LVR lending by the banks highlights their nimble and thoughtful approach.

- A good sense of a "fair go" and equality - NZ's social expenditure as a % of GDP is well above Australia and the US. Additionally, the gini coefficient of income inequality has remained flat over the past 15 years, while it has continued to increase strongly in the US and Australia. Given developed economies are so reliant on consumption for growth, it is critical that there is a healthy middle and lower class as they are the key drivers of consumption. If wealth is disproportionally accruing to the top few per cent of the population, who tend to accumulate wealth rather than spend it (as is currently the case in the US), then it is difficult for a broad based recovery to take hold.

- Strong tourism industry - NZ has a strong "clean and green" image that is likely to continue to increase in appeal – based on the pictures below it is easy to understand why Chinese tourism is increasing exponentially!

*Smog in Beijing – April 2013*

*Mt Cook New Zealand*

- Soft commodities exposure - The NZ economy has a strong bias to soft commodities with dairy, meat, wood, fruit, fish and wine all featuring in their top 10 exports - it is therefore well placed to benefit from the transition of the emerging Asian consumer economies from a fixed asset investment phase to a consumption phase.

- Improving net migration - Outside of Ireland, New Zealand has more of its citizens living outside the country that any other country in the world. Unlike Australia, migration has historically not provided a material boost to population as many Kiwi's migrate offshore, particularly to Australia to chase higher salaries. At the peak of the mining boom there were nearly 40,000 people (or nearly 1% of the population!) migrating to Australia each year! As the mining sector moves from a construction phase to a less labour intensive production phase (meaning miners place more emphasis on controlling costs) and the NZ labour market improves, there has been a sharp slowdown in net migration to Australia over the past 6 months. We expect this to provide an additional boost to household formation and housing starts in NZ over the next few years (providing good support to our investments in SKT and FBU).

- Renewable energy - The vast majority of NZ's power generation is supplied by renewable energy (mainly geothermal and hydro). We believe that this places NZ in a strong environmental and competitive position over the longer term.

Many Australians view NZ as our "poor cousin" – a description which could not be further from the truth. It is a small, nimble and dynamic economy that reset during the GFC and is now growing from a sustainable base, supported by good management and the tailwinds provided by improving net migration and strong demand for soft commodities. While many Australian investors have been scampering to find opportunities to participate in the US housing recovery, we believe the opportunities for Australian investors to get exposure to the NZ recovery are ample.

We note with interest that margin debt on the NYSE is very close to a record high. Margin loans in July of $382.1b were slightly below the all-time record of $384.3b seen in April of this year. Clearly investors remain willing to borrow to fund stock purchases. The chart below indicates why we should be wary as on occasions in the past (2000 and 2007) where margin loans have reached these levels market reversals have followed!