COOPER INVESTORS

GLOBAL EQUITIES FUND (UNHEDGED)

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

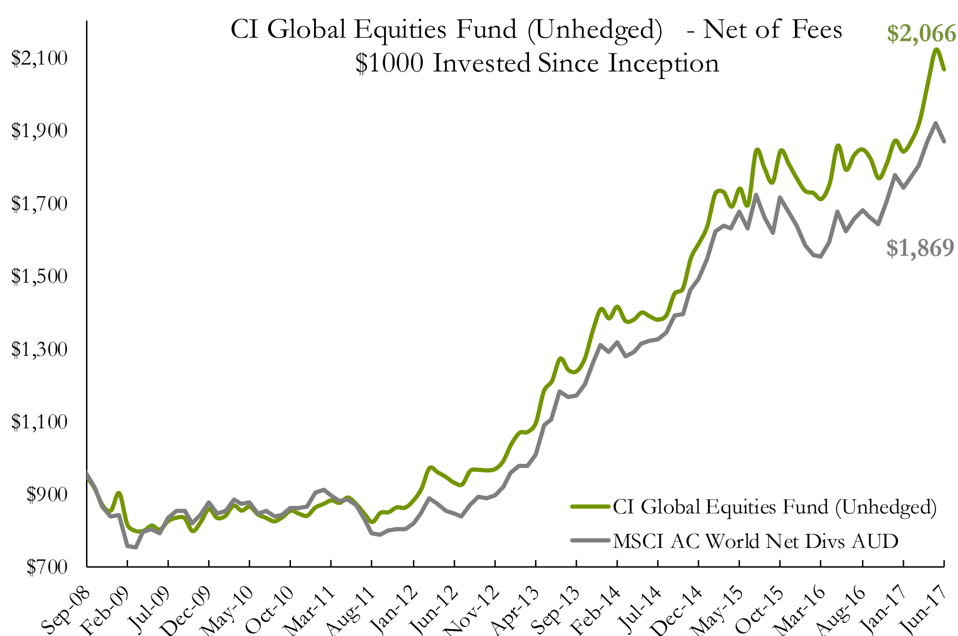
*"I do think we're much safer and I hope that it [another financial crisis] will not be in our lifetimes and I don't believe it will be." **Janet Yellen, Chairwoman of the Federal Reserve***

*"The best way to buy a suit is to get a job." **Emmanuel Macron** (to a demonstrator who attacked him for his expensive suit).*

*"You miss 100% of the shots you don't take." **Wayne Gretzky***

	****PORTFOLIO**	**#BENCHMARK**	**VALUE ADDED**
ROLLING 3 MONTHS	7.78%	3.70%	4.08%
ROLLING 1 YEAR	16.87%	15.31%	1.56%
ROLLING 3 YEAR	15.65%	12.32%	3.33%
ROLLING 5 YEAR	18.76%	17.14%	1.62%
ROLLING 7 YEAR	14.97%	12.01%	2.96%
SINCE INCEPTION*	9.76%	7.34%	2.42%
SINCE INCEPTION^	127.49%	86.92%	40.57%

*Annualised
^Cumulative (1 September 2008).
MSCI AC World Net Divs in Australian Dollars



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Market and Portfolio Performance

Political risk continued to drive markets early in the quarter, with the eyes of the world on France. However, after Brexit and Trump there was to be no third populist uprising, with Marine Le Pen well beaten by reformist Emmanuel Macron. The former investment banker ran an adept campaign that has restored a measure of optimism to the French after years of economic doldrums and morale-sapping terror attacks.

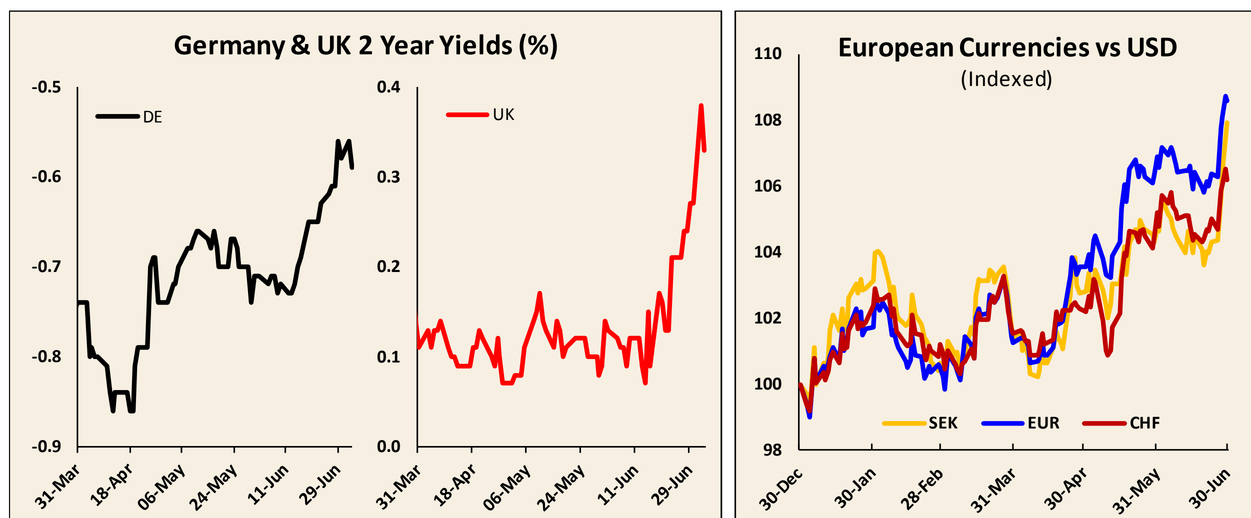
Around the same time, in mid-May, Angela Merkel's Christian Democratic Union party won key state elections in Germany, a result that appears to have strengthened her hand ahead of September's national vote.

These two outcomes, combined with decent economic data, have driven a rally in European equities and the Euro, with the risk of the European Union breaking up seemingly off the table.

The same positive outcome cannot be said for the UK, whose Brexit bargaining position has been considerably weakened by the calamitous general election campaign run by Theresa May's Conservatives. Rather than increase her parliamentary majority, the election resulted in a hung parliament, forcing the Tories to form a cumbersome co-operation agreement with the Northern Irish Democratic Unionist Party.

Equity markets largely brushed this event aside and the focus has now firmly returned to monetary policy, with the Federal Reserve raising the Fed Funds rate by a further 25 basis points in mid-June. Having been held near zero for around 7 years it now sits at 1.25% after three quarter point raises in 6 months. During those 7 seven years, the MSCI AC World (in AUD) has compounded at 14% per annum, a rate of return we see as unlikely to be replicated in the next 7 years.

The most recent hike corresponded with hawkish language coming out of the ECB, with comments from ECB President Mario Draghi suggesting a removal in European monetary stimulus may come sooner than markets had expected. His words led to a spike in short rates on European sovereign debt, along with a further rally in the Euro versus the U.S. dollar late in the quarter. Hot on Draghi's heels was Bank of England Governor Mark Carney, whose comments regarding UK inflationary pressures drove up UK gilts and sterling.



Source: Factset

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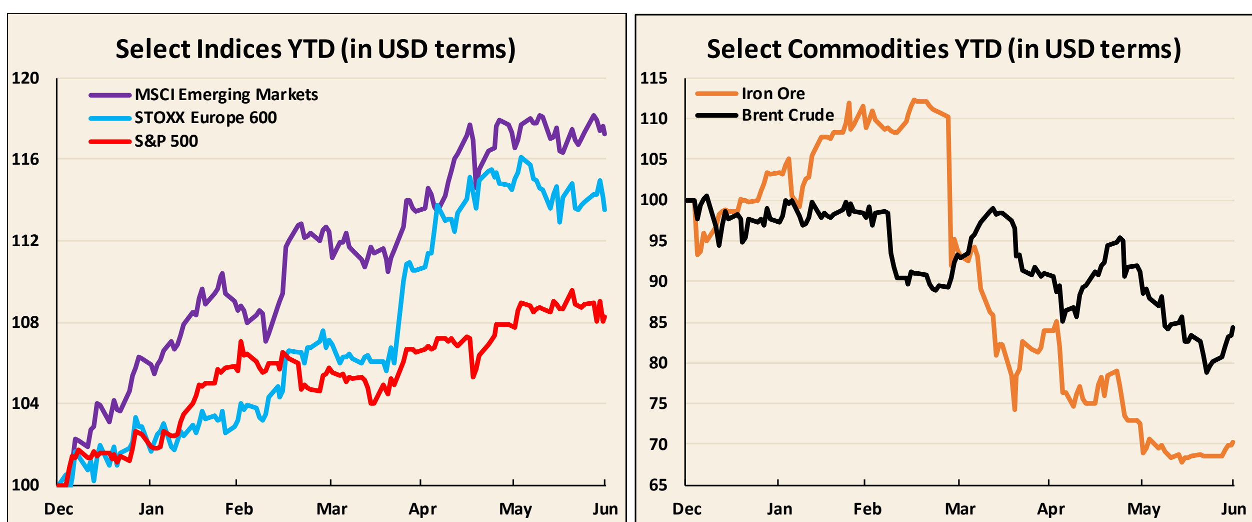
The weakness of the U.S. dollar has accelerated, ending the quarter at 0.87 Euro cents, a decline of almost 10% against the Euro since hitting a high of 0.97 cents on the 3rd January. We note that Trump stayed quiet on the dollar for the first few months of his Presidency; however, in mid-February directly suggested for the first time that he would prefer a weaker dollar to boost US exports. Since then the trade-weighted dollar index is down ~6%.

In this context, both European and Emerging Market equities are having a strong 2017, particularly in U.S. dollar terms, while the commodities complex continues to be under pressure.



Source: Factset

For the three months to 30th June the portfolio returned 7.78% versus the benchmark which returned 3.70% Outperformance was broad-based across the portfolio, with no one Subset of Value or Cluster driving performance. Rather a dozen or so European and US holdings rose double digits and very few stocks fell in absolute terms – indeed none fell by more than 1%

Over the quarter the AUD gained 1% vs the USD and JPY, 3% vs the GBP but fell 6% versus the EUR.

The biggest contributors to performance in terms of total shareholder return in AUD included:

1. **Brinks** – Shares continued to rise on further evidence of the turnaround taking place.
2. **Paypal** – Rose on another strong set of reported results.
3. **Novo Nordisk** – Announced strong clinical study results regarding efficacy for the GLP1 franchise.

The biggest detractors to performance in terms of total shareholder return in AUD included:

1. **Danaher** – The stock was down 1% for the quarter on no material news.
2. **Costco** – Fell 11% in the days after the announced Amazon acquisition of Wholefoods.
3. **Jardine** – After rising 33% in Q1 following inclusion in the MSCI World Index the stock took a breather this quarter.

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The Portfolio

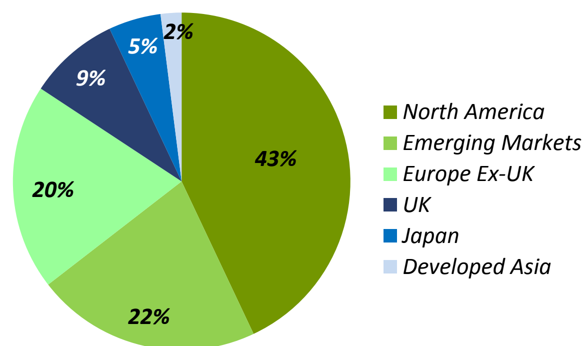
The portfolio is positioned around subsets of value:

- **Growth companies** (37%) – growing companies with identifiable value propositions using traditional value metrics and run by focused, prudent and experienced management (Danaher).
- **Stalwarts** (28% of the portfolio) – sturdy, strong and generally larger companies with world class privileged market and competitive positions (AON).
- **Low risk turnarounds** (13%) – sound businesses with good management and balance sheets. (Brinks).
- **Asset plays** (6%) – stocks with strong or improving balance sheets trading at discounts to net asset value or replacement value (Remgro).
- **Cyclicals** (6%) – stocks showing both upside and downside leverage to the cycle with experienced and contrarian managers who allocate capital prudently. (Ametek)
- **Bond like equities** (4%) – stocks with secure, low-volatile dividends that can be grown and recapture inflationary effects over time (Unibail-Rodamco).

The portfolio is also diversified by country and sector:

No. of Stocks	**43**
Region Weights	**US 53%**
(by listing)	**Europe 27%**
	Asia Inc. Japan 8%
Most OW Sectors	**Industrials, Financials**
Most UW Sectors	**Energy, Materials**
Cash	**5%**

Geographical Exposure by Source of Revenues#



#Derived on a look-through basis using underlying revenue exposure of individual Fund stocks

Buys

During the quarter the Fund initiated a position in **Baxter International**, a leading supplier of medical products to hospitals and renal clinics.

In mid-2015, Baxter spun-off its biopharmaceutical business – this business had historically generated most of the company's operating profit and so the medical products assets received less management attention. Shortly after the spin-off, Baxter appointed Joe Almedia as CEO following a successful stint as CEO of another medical devices company, Covidien.

When we are looking for low-risk turnarounds we are attracted to spin-off transactions like these where a refreshed management team can execute against a clearly articulated pathway to value.

Joe and his management team have made significant progress to date with operating profit margins moving from single digits to mid-teens and we see a pathway for margins to expand well above these levels. Further, there is opportunity for improved R&D practices to drive faster revenue growth. Finally, Baxter's balance sheet is net cash (a rarity in this market) that we believe management will allocate prudently into

value-creating acquisitions. We see material Free Cash Flow growth potential over a multi-year period that is being under appreciated by the market.

Sells

This quarter we sold two long-term holdings that had been reduced to small positions over the past year.

Post a strong period of performance the **General Mills** position had been reduced but maintained as we felt the company's 20% EBITDA margins showed upside compared to what 3G is doing with peer Kraft Heinz, which is generating EBITDA margins north of 30%. However, the industry pressures for General Mills means a declining top line makes the margin expansion opportunity that much more difficult to achieve. We thus exited entirely.

Shoprite was sold after a period of strong performance as their results are defying the South African economy that is on track to deliver its 3rd successive quarter of negative GDP growth. Shoprite is a fantastic retailer and is leading the expansion into Africa that now contributes 15% of profits. However, the 85% portion from South Africa is what concerns us. We hope to be shareholders in Shoprite again one day.

Stock News

This quarter a tender offer for OHL Mexico was launched.

Tender Offer

On 14 June 2017, Magenta Infrastraestructura, S.L. ("Magenta"), a consortium between IFM Global Infrastructure Fund ("IFM") and OHL Concesiones, S.L., a fully owned subsidiary of Obrascón Huarte Lain, S.A. ("OHL"), launched a cash tender offer for the shares in OHL Mexico ("OHLMEX") not currently owned, directly or indirectly, by OHL (representing 42.0%, considering treasury shares, or 42.49%, without considering treasury shares, of the company) at a price of MXN27 per share.

IFM is financing the proposed transaction and although OHL will receive no direct proceeds from the transaction, it will receive a financing package from IFM enabling them to refinance bonds maturing in April 2018 held against around 17% of their OHL Mexico stake. Therefore, OHL is highly incentivised for the transaction to succeed.

The offer was conditional on a minimum acceptance level of 95% (which is the necessary threshold to approve a delisting in Mexico). This was reduced to 85% on 10 July 2017.

We believe the offer price is highly opportunistic and does not reflect the value of OHL Mexico nor its long term development potential. We will not be accepting the tender offer unless there is a material increase in the offer price.

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

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Background

OHL Mexico owns a portfolio of attractive toll roads concentrated in the heavily congested Mexico City. These assets benefit from growing demand, a strong toll culture and a guaranteed return framework on 5 of 7 roads.

In addition to the current portfolio, OHLMEX has the opportunity to leverage its experience, expertise and strong position in the network to develop additional projects in the decades ahead, similar to Transurban's experience on the East Coast of Australia.

Prior to Cooper Investors acquiring a position in OHLMEX in July 2015, the share price suffered around a 45% fall over a 12 month period. The key reasons for this were: 1) allegations of impropriety regarding the tendering of certain concessions[1]; 2) a weak governance structure; and 3) the precarious financial position of the parent company OHL.

Notwithstanding these risks, Cooper Investors recognised the value of OHLMEX's infrastructure portfolio and the opportunity for a dedicated Board and Management team with engaged shareholders to solve these issues, ultimately creating a highly attractive Bond-Like-Equity with stable, long term dividend growth.

To this end, since becoming shareholders we have sought to play a constructive role with the Board and Management. This has included multiple private letters to the Board, meeting Management twice in Mexico City as well as numerous phone calls with Management. In addition, we have met with OHL Management in Madrid, had numerous phone calls with them and engaged with other minority shareholders in OHLMEX.

The focus of our communication has been:

1. Building a governance structure that respects all stakeholders;
2. Designing a capital allocation policy that seeks to grow the long term value of the portfolio, not solving parent OHL's balance sheet issues; and
3. Rebuilding the trust of capital markets.

In our view, the Board and Management, under the leadership of CEO Sergio Hidalgo, have made significant progress over this period in addressing the core issues, including the commencement of a dividend in December 2016. This has been achieved whilst the assets continue to perform strongly, during the most recent 12 month period (to 31 March 2017) OHLMEX recorded average toll revenue growth of 14% with an EBITDA margin of 70%.

Notwithstanding a substantial de-risking and strong fundamental performance, the stock price has continued to lag. This is due to some extent to factors relating to the overall Mexican market including the election of Donald Trump as US President.

It is also due to the continued perception of a weak governance structure and the inability of OHLMEX to articulate a clear investment proposition to minority investors.

[1] Multiple investigations have failed to prove any material wrongdoing

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Offer Price

As mentioned, OHLMEX's portfolio of toll roads stand to benefit from decades of strong traffic and revenue growth, with opportunities for further investment in the network. We estimate intrinsic value of the existing portfolio to be well in excess of the MXN27 per share offer price and note the book value as of 31 March 2017 is MXN41 per share.

Conduct of IFM and OHL

It is our estimation that around 15% of OHLMEX's shareholders are international institutional investors, including Cooper Investors. Therefore, for the transaction to proceed Magenta must convince these investors that the offer price is fair.

Instead, given the material discount of the offer price to our assessment of intrinsic value Magenta and OHLMEX have in our opinion resorted to questionable behaviour that has included:

1. Failure of the Independent Directors of OHLMEX to adequately represent the interests of minority investors;
2. An inadequate independent experts report, which has not made material assumptions available to investors;
3. Lack of genuine dialogue between Magenta and minority investors; and
4. Repeated attempts by Magenta's advisers to create a sense of fear amongst minority investors who do not accept the offer.

It is our expectation that the transaction will fail to achieve the minimum threshold of 85%. However, if the threshold is met, it is unlikely Magenta will achieve anywhere near 95%, providing no immediate path to delisting.

Should the latter eventuate and IFM become investors in OHLMEX, we look forward to working constructively with them to maximise the value of the company for all stakeholders. We believe the addition of IFM as major owners of OHLMEX is an attractive outcome for minority investors because of their strong reputation promoting good corporate governance.

Trip News

This quarter the Global team visited the U.S, Canada and Japan.

In the U.S. we spent two weeks in the Midwest visiting companies in Minnesota, Wisconsin and Illinois. This is our third trip to the US post the election of President Trump. We are definitely seeing management teams at the companies we visit becoming less sanguine on potential large-scale policy reforms around healthcare, tax and infrastructure. For now they are happy enough with a steady state regulatory environment as opposed to the ever increasing burden imposed under the previous administration.

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Given the industrial bent to the Midwest economy our meetings were biased to this group of companies. Since the election last November U.S. industrials have seen both an improvement in their businesses and higher share prices. Emerging markets improving and commodities bottoming on top of the increased confidence from the election have seen industrials produce improved results so far in 2017. However, the euphoria as seen in the stock prices means a sustained recovery is required to justify many of these prices. It feels like the exuberance initially seen in banks has pivoted to industrials.

The Fund does not own any Midwest industrials. Unfortunately, the companies that we define as F1 types (those ranking highest on our focused management behaviour platform) maintained their premium valuations throughout the industrial recession period and never became clear opportunities – though the strong 6-month performance says otherwise.

We also spent a week in Toronto where the main priority was attending the **Constellation Software** annual general meeting and to sit down with management. Constellation is a company that's been in the Fund for over 2 years. Constellation, with an US$11bn market cap, was founded by its CEO Mark Leonard nearly 25 years ago. Mark is the archetypal burning furnace – he is incredibly humble, avoids the limelight and is deeply driven and focused. He stays out of the media and investment community, and only meets with investors for half a day per quarter. His earning calls have no preamble and go straight to questions that usually last no more than 20 minutes.

Constellation is an amalgamation of many different vertical or industry specific software businesses. The company has been built up by acquiring small software companies (those with ~US$10m of revenues) and knowing how to run businesses of this size. Because Constellation isn't a self-promoter we believe the market doesn't understand and appreciate either the quality of these small businesses or the strong cultural aspects that lie throughout the organisation.

The company will be generating ~US$500m of Free Cash Flow and Mark wants to deploy as much of this as possible into high returning acquisitions. The company is certain that it won't lower its return hurdles to deploy all the capital it can – we see a war chest of more than US$1.5bn between the balance sheet latency and annual cash generation. While we don't expect the company to deploy those sums our main takeaway is that the company can keep doing north of US$200m per annum of small deals for the foreseeable future and use M&A to drive double digit contributions to the top line. This is incremental to the underlying business that is consistently growing 3-5% per annum, driven by a steady stream of recurring maintenance revenues. More so if the company can't deploy all its capital into acquisitions, the cash remaining will be eventually returned to shareholders.

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This was our most comprehensive trip to Japan to date, visiting around 45 corporates and industry contacts across Tokyo, Kyoto, Nagoya and Osaka.

The objective as always is to find good VoF propositions, and while in Japan finding companies with good 'O' (i.e. positive operating and strategic trends) is not difficult, matching that with compelling 'V' (price versus our valuation) and 'F' (focused management) can be a major challenge. If management are focused, and especially if they communicate well with foreign investors, we often find the company's valuation is in nosebleed territory – 'Good F, Bad V'.

Alternatively, there are many stocks that appear to offer compelling value, but meeting with management to discuss the company's strategy and business model reveals little in the way of a pathway or even desire to release that value – 'Good V, Bad F'.

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This trip felt like a real breakthrough, and we have now identified a handful of Japanese 'clusters' where the VoF propositions are more likely to stack up. We look forward to increasing the work around these clusters and following these companies more closely. There is no short-cut to success in investing in Japan, and this is why we see not only being on the ground, but getting out of Tokyo into the other prefectures and meeting companies at their place of business as so important. In our experience, it shows them we are serious long-term investors who are genuinely interested in investing in their company.

Our third contact with HIROSE Electric was a trend-positive conversation, with management showing increased awareness of and desire around releasing value from the substantial pile of cash and Treasury shares currently sitting on the balance sheet. We were also excited to hear about the increased share of their high-end connectors that will be on-board the next generation of hybrid cars due to come out from Japanese original equipment manufacturers. These products are high margin, and as sales growth accelerates the impact on cash flow and returns will be virtuous.

We are often asked, 'What's happening with corporate governance reform in Japan'. The answer remains 'It's happening, but slowly'.

As a broader observation from our meetings, companies are continuing to warm up to increasing dividend payouts and buybacks, with most companies dedicating at least a page to this topic in their most recent Mid-Term business plans. Discussions with management also suggest more scrutiny over capital discipline when it comes to acquisitions, and more willingness to exit from poorly performing businesses. Kirin's recent sale of its Brazilian beer business to Heineken and the potential sale of Lion Dairy & Drinks in Australia is a good example.

We are also starting to see more examples of executive share option schemes being put in place, and meeting companies with explicit ROE or Economic Value Added targets is becoming the norm rather than the exception. The widely reported write down of Japan Post's acquisition of Toll Holdings, along with the ongoing crisis at Toshiba, are both major embarrassments for corporate Japan, meaning that governance should remain at the top of the agenda.

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