

CI AUSTRALIAN EQUITIES FUND QUARTERLY REPORT



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

SEPTEMBER 2006

*"...In a garden one must always replenish for the future. Plants must perform or they are gone; design ideas that don't work must be redone".
Dame Elizabeth Murdoch aged 97.*

Bill Clinton on Nelson Mandela "Years ago I asked him this about the day of his release: 'You were a great man, you invited your jailers to your inauguration... but tell me the truth. Weren't you really angry all over again?' And he said, 'Yes, I was angry. And I was a little afraid. But when I felt that anger well up inside of me I realized that if I hated them after I got outside that gate, then they would still have me.' And he smiled and said, 'I wanted to be free so I let it go.' It was an astonishing moment in my life. It changed me."

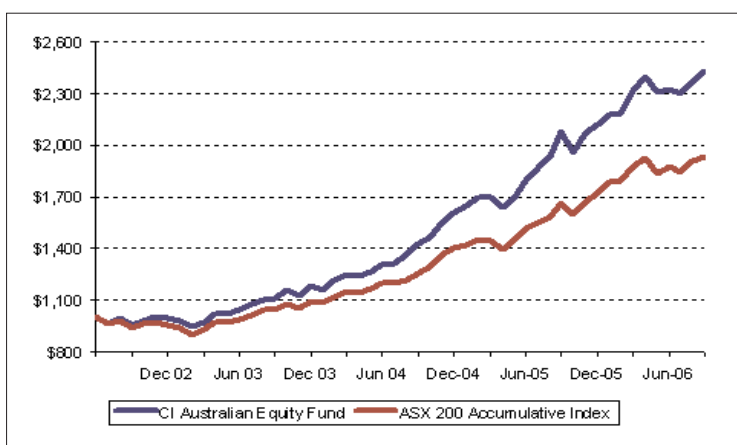
"China will most likely be saving more than the US for years to come. But, as the next generation takes control in China, this will change. Today's children will not view their own life stories from the perspective of the difficulties China has experienced. As this change unfolds, the enormous willingness to save, and to tolerate high saving government policies, will fade." Robert Shiller, Professor of Economics at Yale University

"The abandonment of the gold standard made it possible for welfare statists to use the banking system as a means to an unlimited credit expansion. In the absence of the gold standard, there is no way to protect savings from confiscation through inflation." Alan Greenspan "Gold and Economic Freedom," 1966

PORTFOLIO PERFORMANCE

	PORTFOLIO	BENCHMARK	VALUE ADDED
ROLLING 3 MONTHS	4.40%	2.90%	1.50%
ROLLING 6 MONTHS	4.77%	2.70%	2.07%
ROLLING 1 YEAR	16.83%	15.96%	0.87%
ROLLING 2 YEAR	30.34%	23.81%	6.53%
ROLLING 3 YEAR	29.86%	22.75%	7.11%
SINCE INCEPTION*	23.26%	16.77%	6.49%
SINCE INCEPTION^	142.75%	93.03%	49.72%

* Annualised
^ Cumulative (4 July 2002)



During the quarter the portfolio returned 4.40% and 16.83% for the last 12 months. Positive contributions to the portfolio came from utilities stocks (AGL), transport (Brambles and Toll) and takeover target Mayne Group. We also benefited from the recovery in some previous quarter underperformers such as Healthscope and Toll. Underperformers included the building material stocks (Boral), the energy stocks (Woodside and Oil Search) and the diversified resource sector (Rio & BHP).

We assume that annualized market returns will be closer to 7%-10% over the medium term not the 16% p.a. achieved over the last 5 years. Australia used to be a low PE country but now trades on parity or more to the rest of the world. The industrial sector is on 16.9x forward PE vs. 14.8x for the rest of the world. Our financial sector trades on 14.2x v 12x for the global financial sector. In contrast to Australia this decade the S&P 500 has returned -0.6% p.a. (capital -2.2% + income 1.6%).

Private equity has entered the Australian market with a number of representations to Australian company boards. One of the big drivers to private equity is the availability of funds in the northern hemisphere markets and the fact that Australia is considered a low risk country by overseas debt and equity investors. The risks for directors under the current governance regime make it difficult for directors to focus on commercial matters. Private equity has an advantage in this area because they do not need to report on and manage the ESG (environment social and governance) issues in the same vein as listed public companies. Private companies can allocate resources in a way that best fits the circumstances. Paul Anderson (former CEO of BHP) raises another important question facing Australian industry in a globalizing market. He says, "If you talk to anyone who runs a global company headquartered here, they are probably a physical wreck from travel. Maybe the challenge is to figure out how to capitalize on being a non headquartered country, because if you fight it, and say that you should be centre of the universe, you are not playing to your strengths, you are trying to play a role that will be tough to play...it might make more sense to say ask what is our role in this?"

Private equity leverage ratios have increased from 3x five years ago up to 7x today. Leverage ratios in property have also increased in recent times to the point that it is difficult to negatively gear prime property as yields have fallen below borrowing rates. Recent takeover activity from overseas trade buyers, e.g. Peabody Coal acquisition of Excel Coal, have been done at full valuations. Peabody is paying an enterprise value of A\$920m which is about A\$73/tonne of annual production based on a 13.4mtpa expected in 2008. This compares with the average cost of greenfield project cost of A\$30-\$40 per annual tonne of production.

We recently read an article about Irving Fisher the US economist. Fisher outlines the sequence of events when economies carry too much debt: a random shock triggers a debt liquidation process e.g. an unexpected large drop in stock market values. This creates a forced seller environment. Money stocks start contracting which in turn reduces money velocity. Prices begin to fall. Asset values begin to fall whilst the value of liabilities remain unchanged. Profits start to decline and losses emerge. Consequently net wealth falls and bankruptcies rise. Production, trade and employment are curtailed. Pessimism rises and confidence falls. This causes money hoarding and conservatism of money and a further slowing in the velocity of money. Nominal interest rates fall, however, real interest rates rise because of falling prices. In such situations opportunities become abundant.

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Stock & Industry VoF Trends & Observations

"We have already successfully implemented this business structure in Australia, so we will leverage the know-how and expertise that already exists within the business as we develop our capability in the northern hemisphere". Thierry Soursac, CEO Mayne Group FY06 Results Briefing.

The Mayne Pharma (MYP) board has recommended a takeover (scheme of arrangement) offer by Hospira of the United States for A\$2.6b which equates to 17.9x 2006 EBITDA and 32% above the prevailing price of MYP prior to the bid. We note that 1) the public cost reduction targets, 2) the inclusion of earnings from the recent Nipent acquisition, 3) targeted further improvements in working capital, 4) the one off costs included in the FY06 year not being repeated, and 5) the significant growth in the 2nd half of FY06 being included in the 1st half FY07, all make the adjusted historic multiple (more like 14.9x ebitda, slightly below the average generic takeover multiple, not the top quartile as quoted by the board of directors). If the publicly stated \$50m in cost benefits to Hospira are included the takeover ebitda multiple then falls to 11.5x.

MYP has recently emerged from the shadow of the Mayne Group, undergoing a separation with what-is-now Symbion in Nov 2005, and is essentially a company cobbled together in three significant acquisitions by Mayne Group, which has yet to produce an acceptable return on its invested funds for shareholders, but is in a fast growing part of the healthcare market (injectable generics). The bid comes at an opportunistic time as we feel that with the focus now afforded to it as a standalone entity, the significant investment that has been made into product development and manufacturing over many years, and for the first time a CEO with strong industry experience, a new strategic plan and a cashed up balance sheet, MYP has only just reached a period where its true value and potential can be uncovered and delivered.

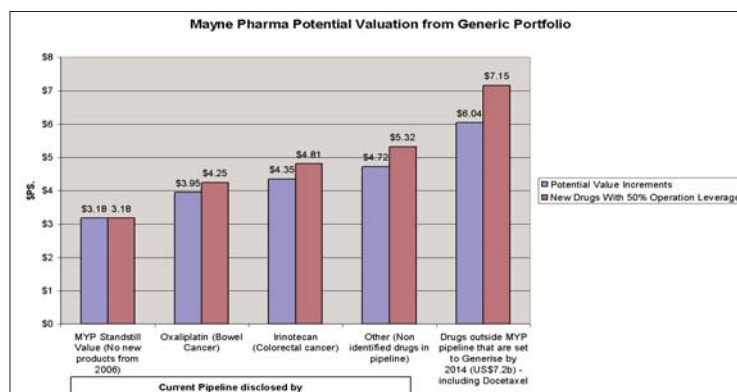
We would note that MYP has publicly announced a drug pipeline of \$4.2b in current local market value oncology drugs which it is targeting to sell when they come off patent. We assume that MYP will target the \$8.2b in oncology drugs set to genericise over the next 8 years.

The current \$4.2b pipeline could add \$97m in EBIT to MYP (+81%) over the next 1-3 years. We value MYP including this disclosed pipeline at \$4.72ps using a discounted cash flow valuation approach.

	Announced Drug Portfolio			Total Potential Value
	Oxaliplatin	Irinotecan	Others	
Local Market Value (US\$)	2100	1100	1000	4200
Generic Value Reduction	50%	50%	50%	50%
Generic Market Share	70%	70%	70%	70%
MYP Generic Mkt Share	20%	20%	20%	20%
MYP Revenue (A\$)	210	110	100	420
Gross Margin	41%	41%	41%	
Gross Profit	86.1	45.1	41.0	172
Operating Costs - SG&A	37.8	19.8	18.0	76
EBIT	48.3	25.3	23.0	97
EBIT Margin	23%	23%	23%	

Source: Cooper Investors Estimates

The largest of MYP's identified opportunities (Oxaliplatin) will start to significantly crystallise during FY07 as MYP launches in Europe (note that it came into Canada in FY06 and this was a major contributor to MYP's profit upgrade in July 2006). Therefore this potential takeover occurs at a time when MYP is literally on the cusp of realising the potential of several years of investment. Given the significant investment already made in staff, facilities, and development we feel that the operational leverage from these new drugs should be significant. Should MYP achieve this leverage we would see significant further upside value to our \$4.72ps.



Source: Cooper Investors Estimates

Cooper Investors has viewed paper as a late cycle commodity and as such we have patiently awaited signs of an upturn over the past three years. Paperlinx (PPX) is a stock previously held in the portfolio and is highly leveraged to the price of fine paper in Europe and Australia. European prices have been hurt by the strong Euro in a weak demand environment and with capacity utilization well below the critical 90%. Likewise the Australian market has been hit by a strong AUD, merchant price wars and cheap Asian imports. In response to these difficult operating conditions PPX has embarked on an aggressive self-help program which is expected to improve operating earnings by over \$100m by 2009. Concurrently we are witnessing some early signs of improvement in the key European market. Just last week Stora Enso announced the closure of the Berghuizer mill representing 2.7% of West European fine paper capacity. Total announced closures should take European coated capacity utilization to around 93% and uncoated to around 90%. Further supporting price increases is the Euro currency pulp price which is up around 20% from the 2004 low. European merchandising represents around two thirds of group EBIT and any recovery in fine paper prices should see margins rise substantially from the current 2.7%. Over the next few months we will be monitoring the sustainability of European paper demand, Euro pulp prices and pulp closures as leading indicators for future paper price rises.

Global Industry Visits

"The fact is that the world has an abundance of oil and there is little question scientifically that abundant energy resources exist. According to the US Geological Survey, the earth currently has more than 3 trillion barrels of conventional recoverable oil resources. So far, we have produced 1 trillion of that." Mark Nolan Exxon Mobil Australia CEO.

"If it bleeds it leads" Media saying

"Every year India is adding the entire energy/electricity capacity of Australia..." Leightons, Wal King.

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We traveled to Asia and USA during the past quarter... We visited 32 companies and 7 USA cities over 10 days, focusing on industries in which Australian companies operate such as healthcare, childcare, building and construction. Some of the themes to emerge included:

- Housing starts, having peaked at 2 million, will inevitably fall below the low of 1.8 million assumed by the NAHB. Builders are tightening their belts, consumers are more highly leveraged, Sunbelt states may feel the heat short term due to more investment and second homes.
- Healthcare in the USA is very complex - different states have different regulations; there are a multiplicity of different payers and reimbursement/rebate arrangements, the nature of the system means most operators have bad debt issues (which is not the case in Australia). Healthcare is 15% of USA GDP (compared to 8-9% in Australia and the UK) and there is pressure from government to contain its spend in this area.
- While we were in the USA the private equity bid for HCA, the largest private hospital operator emerged. While nursing wages rise at a similar rate to Australia, and underlying volume growth is also similar, good private hospital operators run at 50% occupancy rates (compared to 75%+ in Australia), and 60% of admissions come from the emergency room. Funding comes in the main from the government in its different guises and managed care organisations. Bad debts run at 10% of revenue (80-90% of self pay results in a bad debt!). Hospitals are under more pressure from the growth in day surgeries are already present, and to be profitable they need scale/volume which is more difficult to achieve). Compared to Australia the for profit private sector remains fragmented, and operators can still grow by acquiring poorly managed not for profit hospitals and turning them around.
- There is a need for infrastructure investment in many areas. Airports are visibly an opportunity - we have yet to see an airport in as poor a condition as LAX (given its stature as the major Western USA gateway), and almost every other airport we passed through looked run down and, compared to Australia and the UK, under tenanted from a retail perspective. Macquarie Bank has already built a position as the second largest regional airport operator in the USA, and would be hoping to take advantage of opportunities such as the upcoming privatisation of Chicago Midway airport. In addition it would appear that there will be greenfield roads opportunities at acceptable rates of return.
- The energy thematic will continue - while there is no shortage of oil reserves globally there is equally no doubt that in future more oil will have to come from higher cost/more difficult reserves (eg. Canadian oil shale) and more geopolitically risky countries, implying higher capital requirements and higher ongoing operating expense. OPEC has gone from 15m barrels/day spare capacity in 1980s to 1-2m barrels today, NOCs are asking service providers to undertake more technically difficult work, and two Middle Eastern countries at least are looking at heavy oil projects thereby signalling that light, sweet crude is running out.

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