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 2019

"Life is a long lesson in humility." - James M. Barrie

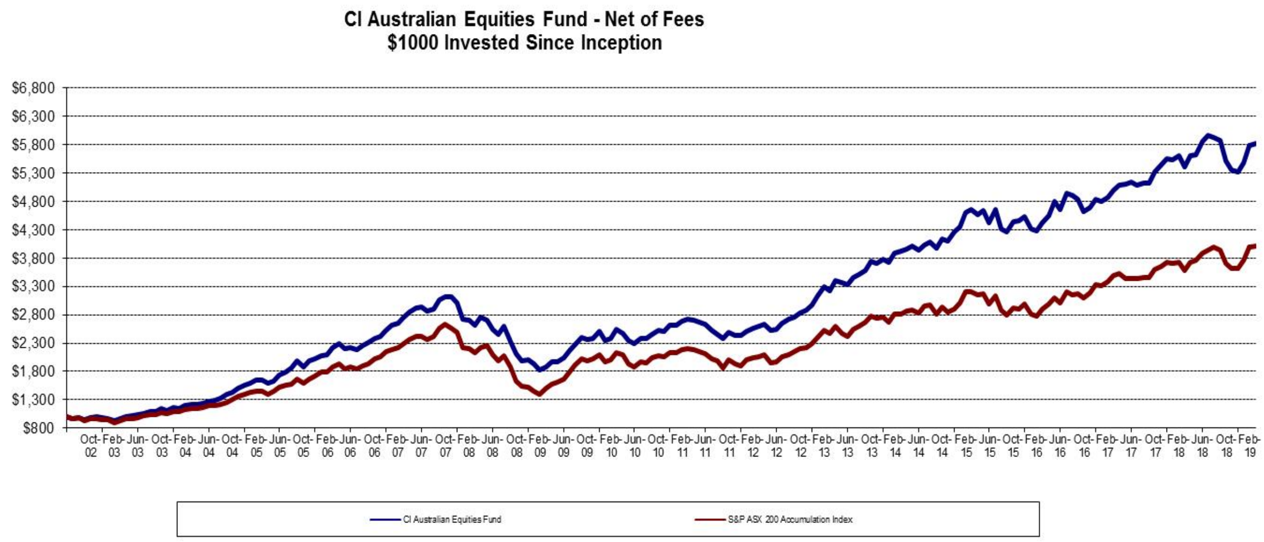
"Your assumptions are your windows on the world. Scrub them off every once in a while, or the light won't come in." Isaac Asimov

"Two things are infinite: the universe and human stupidity; and I'm not sure about the universe." Albert Einstein

"To acquire knowledge, one must study; but to acquire wisdom, one must observe." Marilyn vos Savant

	**PORTFOLIO	#BENCHMARK	VALUE ADDED
ROLLING 3 MONTH	9.67%	10.89%	-1.22%
ROLLING 1 YEAR	8.68%	12.06%	-3.38%
ROLLING 3 YEAR	10.54%	11.47%	-0.93%
ROLLING 5 YEAR	9.44%	7.40%	2.04%
ROLLING 7 YEAR	13.49%	9.97%	3.52%
ROLLING 10 YEAR	13.03%	10.35%	2.68%
SINCE INCEPTION*	12.28%	8.66%	3.62%
SINCE INCEPTION^	595.15%	301.65%	293.50%

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



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Market and Portfolio Performance

Having seen a tough December quarter, the ASX 200 bounced up remarkably well to regain those losses, moving up 10.89% in the first calendar quarter of 2019. The banks sector, although providing positive absolute returns, underperformed the broader market which was led by materials/resource companies and bond like equities (property trusts/real estate). The bounce mirrored overseas markets with the S&P500 up 13.65 %, Euro Stoxx up 12% and the MSCI China up 18%.

Within the portfolio, better performers included Cleanaway (CWY) (strong result and Tox integration on track), OZ Minerals (solid production and cost performance) and Macquarie Group (MQG). The main underperformers were Boral (poor half year result, and management announcements which did the stock no favours – see below for more detail), and Bega Cheese (BGA) (although confirming bottom end of guidance, the drought has increased farmgate milk prices and so put pressure on margin and inventory thereby leading to a fully geared balance sheet which now needs to reduce debt).

As equity markets rose, bond yields fell. The Federal Reserve in the USA changed direction away from lifting interest rates in light of perceptions of weakening global growth (the trade war between the USA and China, Brexit, recent negative GDP growth in Germany all having an impact). The 10 year bond yield in Australia now sits at 1.78% while its US counterpart is at 2.4%, both now well below where yields were twelve months ago. In addition, the spectre of negative interest rates has re-emerged as the German 10 year bond yield went below zero.

Global Supply of Bonds Yielding below Zero, 2017 – 2019

Source: Barclays PLC, Bloomberg

It is quite possible that this scenario is reversed quickly if a trade deal is announced, a Brexit deal is agreed and China's stimulus programs start to have some effect. However in the absence of these resolutions it will be tough for global economic growth to vigorously bounce back. In Australia, the reversal of the longstanding housing market boom and the reduced ability to quickly obtain bank credit is also leading to a slowing of growth, and revenue growth expectations have been lowered by a number of retailers.

The Portfolio

There was a low level of activity over the quarter. No new stocks were added and we sold out of one stock, namely Iluka – this predominantly as a result of concerns over the capital needing to be invested in Sierra Leone having risen substantially from what had been noted at the time of acquisition. However, there were a number of stocks which made important and price moving announcements.

LendLease (LLC) announced that the company will exit from its troubled Engineering and Services division at a cost of $450-550m. We had expected this to be the case but would have hoped for a lower cost of exit – this is effectively the third provision made to account for the very poor performance of this business. We wrote on this in the last quarterly report and our view on the company has not changed. In the short term, however, management will need to exit engineering without further cost and complete settlement on the $1.5B of apartments due in the next few months.

Having demerged **Coles (COL)** and with its balance sheet effectively net debt free, **Wesfarmers (WES)** announced a $1 per share special dividend, and then, more recently and surprisingly, a takeover bid for Lynas Corporation, the rare metals miner. Other than being an opportunistic bid for a company whose share price had been sold down due in the main to political and regulatory issues in Malaysia (the site of its processing facility), it is difficult to see what Wesfarmers brings to Lynas – something we would like to better understand before commenting more fully on the potential deal.

Management of the newly listed Coles has wasted no time in taking action around strategic initiatives, announcing three such deals during the quarter. The first was Coles executing a contract with Witron Australia to develop two new distribution centres, one in south-west Brisbane and one in western Sydney, which will implement a key element of its supply chain modernisation. The second was Coles resetting the alliance agreement with Viva Energy, which (although profit dilutive in the short term) is essential for the future success of the partnership and should enhance the Coles convenience offering through service stations. The third announcement was that Coles has entered into an exclusive partnership with Ocado to improve its online customer proposition. Ocado is a UK-based company which is a leading provider of technology and distribution centres for grocery chains' online offerings. Ocado has built up an impressive list of clients including Kroger in the US, Morrisons in the UK and Groupe Casino in France. These announcements indicate that the recently listed Coles (spun out from Wesfarmers) is acting with some urgency and intent to improve their business albeit that the results of the initiatives will only be seen in three years' time, and execution prowess will be crucially important to success.

Computershare (CPU) continues to perform well operationally, beating market expectations for the 1H19 result and upgrading earnings guidance. However, the share price performed poorly given more subdued expectations for US interest rates (every 100bp move in short-term interest rates has a ~15% profit impact).

While this is unfortunate, we remain encouraged by the strong underlying business momentum, growth and capital management optionality, and focussed management team.

For Macquarie, a rebound in markets, confirmation that FY19 profit would grow another 15% and smooth leadership transition were all supportive. The appointment of the highly-regarded Shemara Wikramanayake as new CEO highlights the depth of talent in the business and strong succession planning. Wikramanayake has spent over 30 years with the company, which includes delivering stellar results while running Macquarie Asset Management. The long-time global head of Commodities and Global Markets, Andrew Downe, has also stepped down. He is also being replaced by a high-quality successor, Nicholas O'Kane. O'Kane has been integral in building the Commodity Markets and Finance business into a powerhouse.

Boral (BLD) has recently made two announcements relating to its management team. The first made clear its two main/preferred internal candidates to succeed CEO Mike Kane, but despite a preference for internal succession (rightly so) did not rule out a wider search. The second announcement was more concerning for us – namely that CEO Mike Kane would be going onto the **SimsMetal (SGM)** board. Our issue with such a move is one of time and focus – we would have thought that Kane had more than enough on his plate at Boral. He is managing a multi national business with a number of sub businesses, he has yet to deliver on the acquisition of Headwaters, recent results have been worse than average and need serious improvement, and in addition there is the ongoing negotiation of the plasterboard joint venture with Knauf. In our view, these activities should consume all his time, especially so in light of the company's share price performance. To go onto another board as things stand today we believe risks recovery in Boral's underlying performance.

A little time after putting out a result showing good revenue growth but little profit traction (and holding to prior guidance of improved profitability in its US pallet business over the next two years), **Brambles (BXB)** announced the sale of its IFCO plastic crate business to a wholly owned subsidiary of the Abu Dhabi Investment Authority. Although there was an embedded long term growth option in this business which would have remained attractive to shareholders but would have required capital investment, Brambles received a reasonable price and will be returning most of the capital to shareholders via a special dividend ($300m) and a share buy back ($1.95B)

Trip Notes

Following 35% underperformance in 4Q18, **Clydesdale Bank (CYB)** stabilised and outperformed the market this quarter. The main catalyst for the earlier decline was guidance that the net interest margin would decline 4-10% in FY19 (to 160-170bp). The majority is attributable to the recently-acquired Virgin Money business. This was compounded by the ongoing drag on capital generation from PPI charges and Brexit-related uncertainties. This quarter's performance was supported by a more encouraging 1Q19 update, which lifted the bottom end of margin guidance to 165bp.

Our recent trip to London confirms that operating conditions remain tough. Margin pressure persists on both sides of the balance sheet: major banks still have substantial surplus liquidity in UK ring-fenced entities to deploy into lending, while funding competition could escalate as the industry looks to refinance Term Funding Scheme (TFS) money and meet Minimum Requirement for own funds and Eligible Liabilities (MREL) obligations. Costs are proving hard to remove given regulation and technology investment. While banks want to lend, Brexit is dragging on confidence and demand for credit. Most economic indicators are stable, so impairment charges should remain low. However, IFRS 9 will create upward pressure as it is based on more forward-looking provisioning.

Industry structure is also challenging. Extensive use of broker-led distribution reduces pricing power on the asset side, while surplus liquidity fuels front-book mortgage competition. The major banks have a distinct advantage on the liability-side given customer inertia on deposits, capital advantages and a superior breadth of funding options.

Value latencies inside CYB include upside from the RBS Incentivised Switching Scheme (Williams & Glynn), ongoing capital optimisation and further cost-out opportunities (inc. Virgin Money integration). CYB is also well positioned to participate in any industry consolidation, albeit the PRA is unlikely to approve it until Virgin Money is properly integrated.

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During the quarter we visited participants in the US online real estate industry. The online real estate model in the US is very different to Australia. In the USA there are buyer and seller agent commissions (2-3% each), which are all paid by the vendor. All marketing fees are included in the agent commission. This compares to Australia where there is only a seller agent commission and marketing expense is paid by the vendor. For Zillow and Realtor (owned by **NewsCorp (NWS)**), their revenue predominantly comes from the buyer agents, who pay on a leads basis (ie. the online portals deliver leads to the agents when a customer enquiry is made). There are more than 1.2m real estate agents in the US and the average salary is in the range of $35-$50k. We expect the number of real estate agents to decline in coming years. The size of the US market is large with the buyer commission pool of circa US$31bn (2% of 5.5m transactions at a $280k average house price) while combined revenue of listed portals is US$2.34bn (the largest being Zillow US$1.4bn, Realtor US$0.45bn and Redfin US$0.49bn), which accounts for only 7.6% of the commission pool. The opportunity is to shift more of this commission pool online, albeit competition is intense. This compares to Australia where realestate.com.au and Domain generate a combined revenue of circa AUD$1B in a market where transactions have averaged 500,000p.a. historically.

To date the Zillow leads model has been slightly different to the Realtor model. For Zillow, real estate agents bid for impressions for a suburb/zip code (subscription fee) i.e. the higher price bid, the more impressions and leads received. Zillow allocates leads on a priority basis dependent on the subscription fee paid by the real estate agent. Zillow only passes the lead to one agent. For Realtor, real estate agents pay a subscription fee for buyer leads. The price of a lead is dependent on area and demand. Unlike Zillow, the buyer agent’s profile is not displayed on a listing and all enquiries from interested buyers are made through a general enquiry. Realtor then sends the lead to two agents. If Realtor can’t meet the agreed number of leads, the real estate agent is refunded the difference. Although the price of a lead from Zillow is more expensive, the value of a Realtor lead can diluted as a lead is sent to two agents.

However, the business models for both businesses are changing. Zillow are implementing the ‘Concierge’ service and Realtor recently acquired the Opcity business. With the ‘Concierge’ service, all general enquiries are contacted by a Zillow representative before the lead is connected to a buyer agent. This is likely to result in lower leads passed to agents as Zillow will only connect interested buyers to agents. However this should result in real estate agents becoming more productive as they should receive higher quality leads. Ultimately, the strategy is moving towards a full referral lead basis, which would result in Zillow receiving 30-35% of the buyer agent’s commission. This is a similar approach Realtor is taking with the acquisition of Opcity. Over time, this model should lead to fewer paying agents as both companies are likely to refer leads to real estate agents with better conversion rates. The decision to change the business model suggests that the pricing power of the existing subscription model is limited.

Zillow have stepped out their business model further by moving into the iBuyer market, which involves purchasing a property from the vendor at a discount of ~10%, making some renovations and selling the house at closer to fair value. The risks of this model include the relatively capital heavy nature of the venture, the fact that it could be seen as competing against the customer (agents), and that turnover of property is slower than expectations and the price moves against them during their holding period. Zillow is still required to pay a buyer agent fee on sale of property. If the vendor decides not to take up Zillow’s offer, Zillow could potentially sell this lead to a seller agent, which is an area Zillow/Realtor have not been able to monetise. It appears to be a market Amazon could potentially enter as a play would be on the entire consumer life cycle i.e. install Amazon related devices in homes. Realtor have at this stage elected not to follow Zillow down this route.

Having grown the business since acquiring it some four years ago, Newscorp are continuing to invest heavily in Realtor in order to keep expanding the business. The appointment of Tracey Fellows (ex CEO of Real estate.com) as CEO of global real estate for Newscorp presages an attempt to cross collateralise the skills and capabilities from the two organisations as well as an attempt to bring to the forefront the value of Realtor in the Newscorp share price. This may well require some structural re-alignment of the ownership of Realtor and greater transparency around its financial metrics.

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