# CI BRUNSWICK FUND
# QUARTERLY REPORT

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

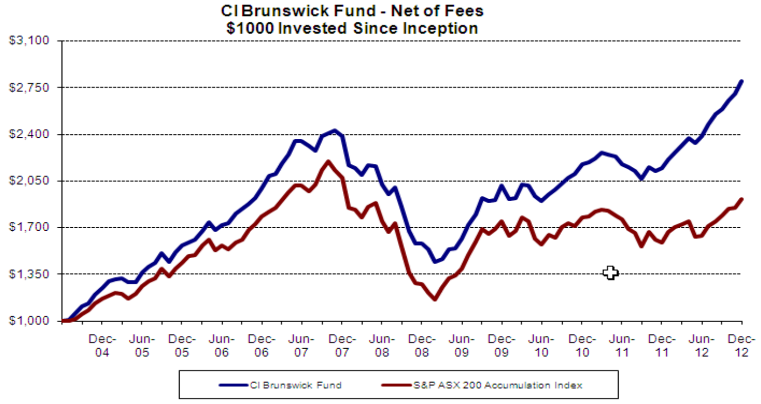
## DECEMBER 2012

***"Nothing happens until something moves." Albert Einstein***

***"The best way of preparing for the future is to take care of the present, because we know that if the present is made up of the past, then the future will be made up of the present. All we need to be responsible for is the present moment. Only the present is within our reach. To care for the present is to care for the future." Buddhist saying***

"***God, give us grace to accept with serenity the things that cannot be changed, courage to change the things which should be changed and the wisdom to distinguish the one from the other." Reinhold Niebuhr***

| | **PORTFOLIO | BENCHMARK | VALUE ADDED |
|---|---|---|---|
| ROLLING 3 MONTH | 8.51% | 6.94% | 1.57% |
| ROLLING 1 YEAR | 32.03% | 20.26% | 11.77% |
| ROLLING 2 YEAR | 15.70% | 3.72% | 11.98% |
| ROLLING 3 YEAR | 13.51% | 3.00% | 10.51% |
| ROLLING 5 YEAR | 4.76% | -1.62% | 6.38% |
| ROLLING 7 YEAR | 11.36% | 4.15% | 7.21% |
| SINCE INCEPTION* | 16.76% | 7.92% | 8.84% |
| SINCE INCEPTION^ | 273.55% | 91.25% | 182.30% |

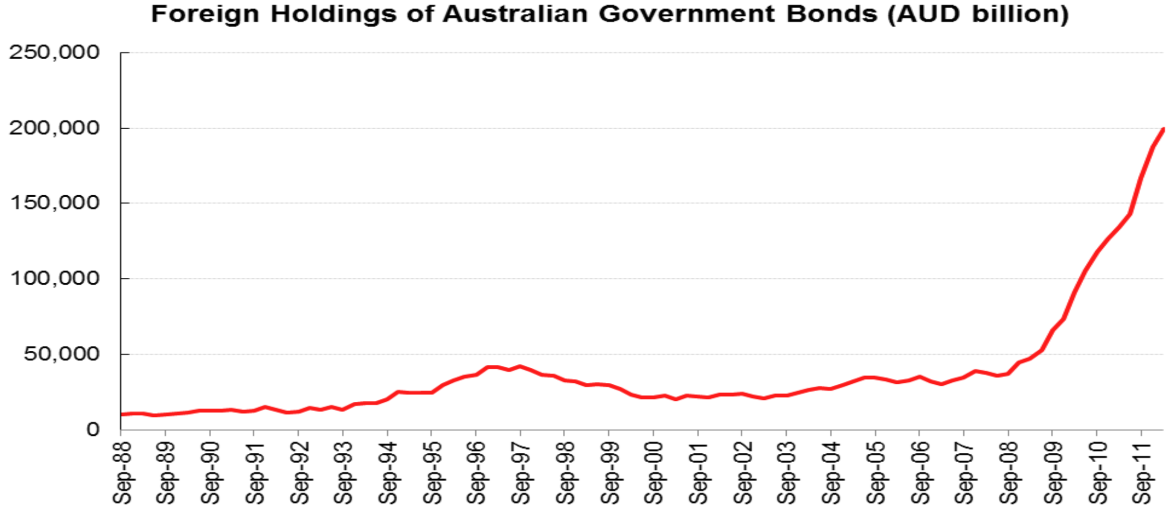



* Annualised
^ Cumulative (1 July 2004)
** Before fees and expenses

## Market and Portfolio Performance

The portfolio returned 8.51% and 32.03% over the quarter and year. Performance this quarter was driven by the international holdings in Rio PLC and Standard Chartered Bank, the Australian listed but very much global healthcare company, CSL and share price recoveries in Navitas and NIB Holdings. Under-performers were Oil Search, Amalgamated Holdings, Vodafone and Woolworths.

The calendar year has ended on a good note and sees Australia once again returning to the winners circle. The ASX200 accumulation is up 20.3% compared with the S&P500 16.0%, NZ 24.2%, Germany 29.1%, UK 10.0%, France 20.4%, Japan 20.9%, HK 26.4% and another poor year from China 3.2%. Over the year the AUD appreciated 1.7% and commodities were mixed copper 5.9%, aluminium 1.3%, nickel -7.5%, oil -9.8%, gold 7.0% and iron ore 4%. The Australian bond market returned 7.7% and remains an asset class of choice for overseas investors.



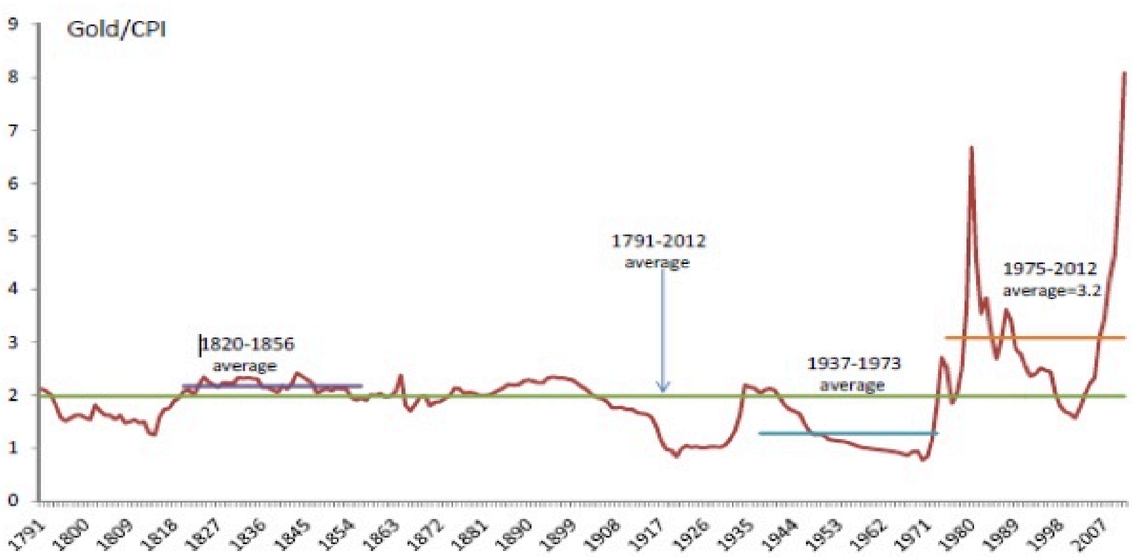

*Source: Australian Office of Financial Management*

Notable out-performing sectors over the year included Banks 30.3%, REIT's 33%, Telecom 42.3% and Healthcare 49%. Under-performers were dominated by energy -0.2% and metal and mining 3.3%. Big cap stock under-performers over the year (but not currently held in the portfolio) were stocks Newcrest -24%, Santos -7%, Lynas -45% and QBE -11%.

Much of the market's performance came on the back of PE expansion. The market PE has increased 2pts over the year and now trades on 13x whilst at the same time EPS fell by around 7.5% compared with the 10-15% expected growth in analysts' forecasts last year.

Loose global monetary policy (evidenced by the real gold price chart below), improved clarity around global policy settings, more positive data points from China and the valuation of equities relative to bonds have all conspired to support strong equity price moves.

**Exhibit 8. The Real Price of Gold over 200 Years**




*Source: Australian Office of Financial Management*

It is clear from our recent company meetings that the underlying operating conditions for domestically exposed businesses remain difficult and that the "real" economy is a lot weaker than the "financial" economy. First half results are likely to provide the quantitative support to the qualitative comments we have been hearing from management and we continue to be biased towards companies who are in control of their own destiny and have adapted to the tougher operating environment, rather than those who are relying on an improvement in the macroeconomic backdrop.

## The Portfolio

"The line that I always like to use about dividend income is that since NASDAQ's inception in 1971, utility stocks have out-performed NASDAQ. That's incredible and it shows you the power of compounding dividends over a very long time frame." Rich Bernstein.

The portfolio is positioned around five pillars or stock clusters:

- **Bond like equities** (18% of the portfolio) – (such as Transurban) which can grow their good cash dividend yields as well as recoup inflation under the terms of their long life contracts.
- **Asset plays** (19%) - with good balance sheets (such as Jardine Strategic and Soul Pattinson, both of which sell below sum of the parts replacement value).
- **Niche growth** (20%) - stocks with focussed, prudent and experienced management teams operating in industries and product segments that can generate high sales and profit growth. Importantly though, the growth stocks must display growth, value, quality management and sound business models. Examples include Ryman (demographic and age care play) and some of our Asian stocks such as Vitasoy.
- **Turnarounds** (6%) - sound businesses with management in place and good balance sheets essential (QR National). We especially like government to private turnarounds.
- **Stalwarts** (32%) - sturdy, strong and generally larger companies with world class privileged market and competitive positions (News Corp, Woolworths).

Currently the portfolio has around 4% in cash and another 5% in high yielding hybrid securities such as Australand Notes and Transpacific Preference shares.

The portfolio has around 14% of assets invested in overseas markets (excluding NZ stocks) or 17% (including NZ stocks). These are spread across the UK, Singapore & Hong Kong listed companies.

Portfolio attributes as at December 2012 are summarized below.

| | |
|---|---|
| PE | 15.1 x |
| Beta | 0.69 |
| Yield | 4.3 % |
| P/Book | 1.9x |
| ROE | 12.6% |
| Tracking error vs. ASX 200 | 5.96% |
| Stock Numbers | 37 |

Major sector exposures are:

| Sector | Portfolio Weight |
|---|---|
| Energy | 2.7% |
| Materials | 4.5% |
| Industrials | 24.5% |
| Health Care | 10.3% |
| Financial | 17.3% |
| Utility & Infrastructure | 9.4% |
| Telecommunications | 8.7% |
| Foreign Equities * | 13.6% |
| Cash & equivalents | 9.0% |

* Excludes NZ stocks which are considered domestic along with Australian listed securities

## Stock News

*"Do you know the only thing that gives me pleasure? It's to see my dividends coming in…" J.D. Rockefeller.*

**Oil Search (OSH)** ~ In November the operator of the PNG LNG project (Oil Search owns 29% of the project) provided a project update. The surprise was that the estimated project cost has increased from US$15.7bn to US$19.0bn. As the project is 70% complete the increase in cost is substantial and was unexpected, albeit all other gas projects in the region had previously announced substantial cost overruns. The increased costs are due to a weaker US$, delays and land access issues and adverse weather issues. The impact on the Oil Search share price was swift with the stock falling 7% in the week of the announcement. Oil Search has ample funding to pay their share of the increased cost. First gas is still expected in 2014 and the project economics remain very attractive. On a more positive note OSH has announced results from a well in Iraq that indicate a substantial oil find. It is very early days and until further appraisal of the discovery is conducted (probably first half 2013) there will be limited impact on the share price.

**Westpac (WBC)** ~ Westpac announced their annual results in October. The results showed a moderate increase in profits and slightly higher increase in dividends. Westpac stated that their target for Tier 1 common equity capital ratio under Basel 3 would be in the range of 8-8.5% and they currently have a capital ratio of 8.16%, in other words they will not have to keep increasing capital ratios from current levels.

**Lifestyle Communities Ltd (LIC)** ~ LIC was added to the portfolio during the quarter through participation in a $36.5m equity raising. The equity raising allows LIC to reduce gearing and positions the balance sheet so that management can make long-term value adding and strategic decisions whatever the prevailing market conditions. The LIC business model is to develop a portfolio of residential communities which generate low risk annuity rental and deferred management fee (DMF) income streams growing at or above CPI. The ability to recoup development capital via unit sales is a crucial element of the business model; however, we do not see LIC as a property development company. Rather, we see it as an annuity business (an anathema to property development). We expect distributions to shareholders will grow steadily over time as communities mature and the associated annuity income streams grow. The governance structure is a high quality, independent, non-executive director controlled board, including the Chairman (Tim Poole) and chairs of the Audit Committee and Remuneration Committee.

**APA Group (APA)** ~ During the quarter we accepted the APA bid for our HDF securities after completing comprehensive due diligence on APA. We received 0.39 APA securities and $0.80 cash per HDF security. We are attracted to APA for the following reasons:

- APA has a strong track record since listing in 2000 having grown its assets from $1bn to over $9bn and delivered a ~600% total return to security holders – a pretty impressive outcome for so-called "boring" regulated pipeline assets! As an aside, it is interesting to observe that the returns achieved by its portfolio of regulated assets have far out-stripped those of AGL in unregulated generation assets.
- APA has an extremely high quality portfolio of energy infrastructure assets – key asset attributes include:
    i. Own over 14,000km of gas pipelines;
    ii. Delivers half of Australia's domestic gas usage;
    iii. Stable and predictable cash flows underpinned by contractual or regulatory arrangements → 98% of revenue is derived from either price regulated or contracted assets;
    iv. More than 80% of revenue is capacity based (i.e. take or pay) therefore relatively unaffected by volume variability; and
    v. Average contract term of 12 years and 85% with investment grade counterparties.
- Strong ability to reinvest significant amounts of capital back into the business at attractive rates of return. From FY07-FY12, APA invested ~$1.2bn on organic capital expenditure projects and believes it will be able to spend an additional ~$600m over the next 2 financial years. The vast majority of capex is supported by long term revenue arrangements with customers or included within the regulatory pricing framework.
- While APA has undertaken small step-out projects in what we would consider to be "non-core" assets (namely the Emu Downs Wind Farm and the joint venture development of the Diamantina Power Station) we have an expectation that pipelines will remain APA's core business and this was re-confirmed by the Chairman at the 2012 AGM.
- Unlike some other listed infrastructure assets, APA has direct management and operational control over its assets and investments with no fee leakage or conflicts that arise with an external management model. APA employs over 1,400 people across commercial, engineering and operational functions.
- Favourable regulatory regime, including:
    i. Tariffs on core services are set by regulation but APA retains the ability to contract for services outside of the regulatory framework. The proportion of APA's assets that are subject to the full WACC / RAB regulatory regime continues to decline;
    ii. Staggered reset dates for APA's regulated assets – access arrangements are generally set every 5 years; and
    iii. Tariffs commercially negotiated for all other pipelines, new capacity on most pipelines and gas storage.
- While APA's balance sheet carries a significant amount of debt with gearing at ~65%, the highly predictable nature of the asset cash flows allows it to easily support this debt load and it has a sound BBB credit rating. APA has shown a strong ability to access capital markets and recently issued GBP 350 million 12 year notes at an attractive rate, its first issue in the sterling market. APA's gearing level largely precludes it from acquiring assets that do not have contracted or regulated cash flows.
- Trades on an attractive dividend yield of 6% at a payout ratio of 67%. We believe that APA has the potential to increase the payout ratio over time as its capital expenditure program slows. On a like for like basis, APA's cash flow yield is 3-4% higher than Transurban and Sydney Airport (who both pay out 100% of operating cash flow). While APA may have a slightly lower growth profile, we believe that its assets are lower risk given that it is largely take-or-pay contracts and thus such a yield premium is not justified.
- We have a base case DCF valuation of over $6 which is highly sensitive to changes in the discount rate assumptions (i.e. decreasing the cost of equity by 1% will increase our valuation by over $1). There is clear evidence that some investors required return for long duration assets with predictable earnings streams are decreasing.

The listed infrastructure sector has undergone a dramatic transformation over the last 3-4 years. Prior to the GFC it was characterised by highly leveraged structures in which increasing amounts of debt were applied to the stable cash flows of the assets to essentially bring forward equity cash returns and many assets had huge fee leakage via external management agreements. Over the last few years there has been a big reset across the sector with most companies adopting more conservative capital structures, external management agreements have been scrapped and they have moved to more sustainable distribution policies (i.e. paying distributions out of operating cash flows). The underlying quality and stability of these assets has become far more apparent since the "financial engineering" has been removed and there has been significant corporate activity in the sector.

**Amcom Telecommunications Ltd (AMM)** ~ Amcom Telecommunications Ltd (AMM) is an Australian-based telecommunications and IT services company listed on the ASX in 1994. AMM owns and operates a fibre network spanning over 2,200kms, accessing over 1,400 buildings in Perth, Adelaide and Darwin. In other capital cities AMM accesses third party networks to achieve national coverage. Key products and services includes delivering business grade data and network services via AMM's fibre network, communications and IP voice, data centre services, cloud solutions and managed services (network, infrastructure, desktop and IT service management). AMM's customer base is predominantly large corporate and government, as well as wholesale (telco) customers and resellers. AMM's only competitor in its key market of Perth is Telstra, and with only 10% market share AMM has plenty of scope for continued growth.

AMM has a stellar track record of ten consecutive years of underlying net profit growth of more than 20%. The management team is very credible and they have created a strong sales and customer service culture, which are viewed as key competitive advantages over larger competitors such as Telstra. Capex has now largely been sunk and free cash flow is increasing strongly. The provision of Cloud services (e.g. hosted telecommunications and IT services) represents the next stage of AMM's growth profile. AMM is in a strong financial position with very low gearing which provides some latency in its balance sheet. Our current valuation is about 10% above the share price and we feel there is a reasonable possibility AMM will exceed our revenue forecasts.

**Agriculture** ~ there is an increasing level of consolidation taking place across the Australian agriculture sector with interest from two types of buyers;

i. Global agriculture giants looking to add value by integrating Australian assets into their global supply chains; and
ii. Emerging markets concerned about food security and looking to future-proof supply.

The listed Australian agriculture sector has been a perennial under-performer. Unfortunately the sector has not capitalised on its comparative advantage in production in the way our natural resource companies BHP Billiton and Rio Tinto have established themselves as global resource champions. The success of our miners has had enormous implications for Australia's terms of trade and supported the investment boom we have enjoyed over the last decade. Over the last 12 months, the list of completed or proposed transactions in the sector is extensive:

| | |
|---|---|
| 04/12/12 | Graincorp (GNC), Australia's largest grain handler received a revised takeover offer from US giant Archer Daniels Midland (ADM) for $12.20 per share, effectively valuing GNC at $2.8bn. |
| 30/11/12 | New Zealand dairy cooperative Fonterra raised NZ$500m via the Fonterra Shareholders Fund. |
| 29/10/12 | Elders Ltd (ELD) announced a decision to sell its core Rural Services business as part of an accelerated strategy to return value to shareholders. |
| 12/10/12 | McGrathNicol announced the sale of Cubbie Station, Australia's largest cotton farm and irrigation operation to a Chinese/Japanese consortium. |
| 16/03/12 | Thai sugar giant Mitr Phol completed its acquisition of Australia's 4$^{th}$ largest sugar miller, MSF Sugar (MSF). |

Over the quarter we made two investments in the agriculture sector, establishing positions in Bega Cheese (BGA) and PrimeAg Australia (PAG).

**Bega Cheese (BGA)** ~ key points around the investment proposition include:

- The immediate assumption for most people is to think of BGA as a consumer goods company exposed to the significant market power of the supermarkets. This, however, is not correct. Bega manufactures, cuts and packages cheese for a range of customers (including private label) and charges based on a targeted return on capital (i.e. it should be thought of as a toll manufacturing business). Fonterra manages the Bega brand under a franchise agreement and it has $200-250m in annual sales.
- The key success factor (and significant barrier to entry) is plant utilisation. BGA has ~80% of the installed capacity for cutting, packaging and processing cheese in Australia with shredded cheese and naturally sliced cheese close to full capacity. The economics for a new entrant are not attractive with a $100-150m capital investment and a requirement to price contracts at losses in order to fill capacity.
- The export orientated nutritionals / infant formula business at Tatura is an extremely high quality business. This business is more akin to a pharmaceutical business than a manufacturing business given the importance of the product being produced with extremely high quality standards. Demand for infant formula is growing at double digit rates in emerging markets. This business alone is likely to be worth at least 6x EBITDA which would account for close to 80% of the current enterprise value.
- We have high regard for the experienced CEO and Chairman.
- The move from a co-operative structure to that of a listed company structure will enhance the management and board's focus on returns and is likely to lead to improved financial metrics over time.
- The business has been very focused on moving away from commodity type products over recent years which is lowering the earnings volatility of the business.
- BGA will be a beneficiary from a falling AUD.
- We believe that BGA can deliver 10% + EBITDA growth in FY13 due to enhanced utilisation (primarily driven by a Coles private label contract) and avoidance of some one-off costs in FY12 associated with a fire at their Coburg facility. Based on the current share price of $1.80, BGA trades on a PE of 11x, fully franked yield of 4.4% and well below our conservative DCF valuation. Cash flow should also improve markedly as the business cycles the one-off working capital build associated with the Coles contract in FY12.

**PrimeAg Australia (PAG)** ~ key points around the investment proposition include:

- PAG is a listed agriculture investment company that owns a portfolio of rural properties, water entitlements and undertakes cropping and livestock activities.
- In late August PAG announced a decision to privatise the company (by way of public tender) in an attempt to close the gap between the stock price and Net Asset Value (NAV), with an expectation of identifying final proposals by end CY12 and settlement around 1Q13.
- At the time PAG was trading at around $1.08 compared with NAV $1.43 (after adjusting for the 15cps distribution post balance-date).
- PAG's NAV composition is diversified with the largest land/water aggregation asset valued at $0.18 per share. The NAV is predominantly made up of cash ($0.47), land assets ($0.52) and water entitlements ($0.31).
- In late July PAG completed the partial sale of properties at Inner Downs and North Star for $36.7m, broadly in-line with the most recent independent valuation and book value. We believe this lends support to the underlying value of the remaining assets.
- Recent observable market transactions for comparable properties (Cubbie Station) and water entitlements (Federal Government water buy-back scheme) also highlight the disconnect between the listed and unlisted market for Australian agriculture assets.

DECEMBER 2012

## International Trip Observations from CI's investment team

**European Trip**

- There is universal opinion amongst corporates that they need to position for derisking, deleveraging and the fiscal and social cliffs.
- The worlds new emerging market ~ The GSA (Gulf States of America). "Alabama, USA is the new car industry of the future" (Thyssen Krupp).
- Brazil no longer low cost (Thyssen Krupp).
- Czech Republic a nice low cost growth proxy on Germany.
- China beverage market demand needs to catch up with supply so 2013 will be slow.
- Buying businesses from PE firms could be described as buying "pork with lipstick".
- The world is growing just not OECD.
- Cultural disharmony continues to rise ~ deep underlying disunity with Muslims and immigration in Germany.
- Chinese love high quality industrial products from Germany and high quality fashion goods from France.
- Unions in Germany whilst very strong appear to understand the need to remain competitive.
- Sub regions of Europe are very strong e.g. Northern Italy unemployment 6%; Bavaria is 3-4%.
- Utility regulators in Germany have been brutal e.g. E.On has incurred a €700m p.a. penalty regarding the forced closure of their nuclear plants by 2022.
- Close Brothers (UK specialist asset finance company) has been growing assets at 20% p.a. for last 3 years even though market has shrunk due to £80b capacity withdrawal (last man standing) .

**US Trip**

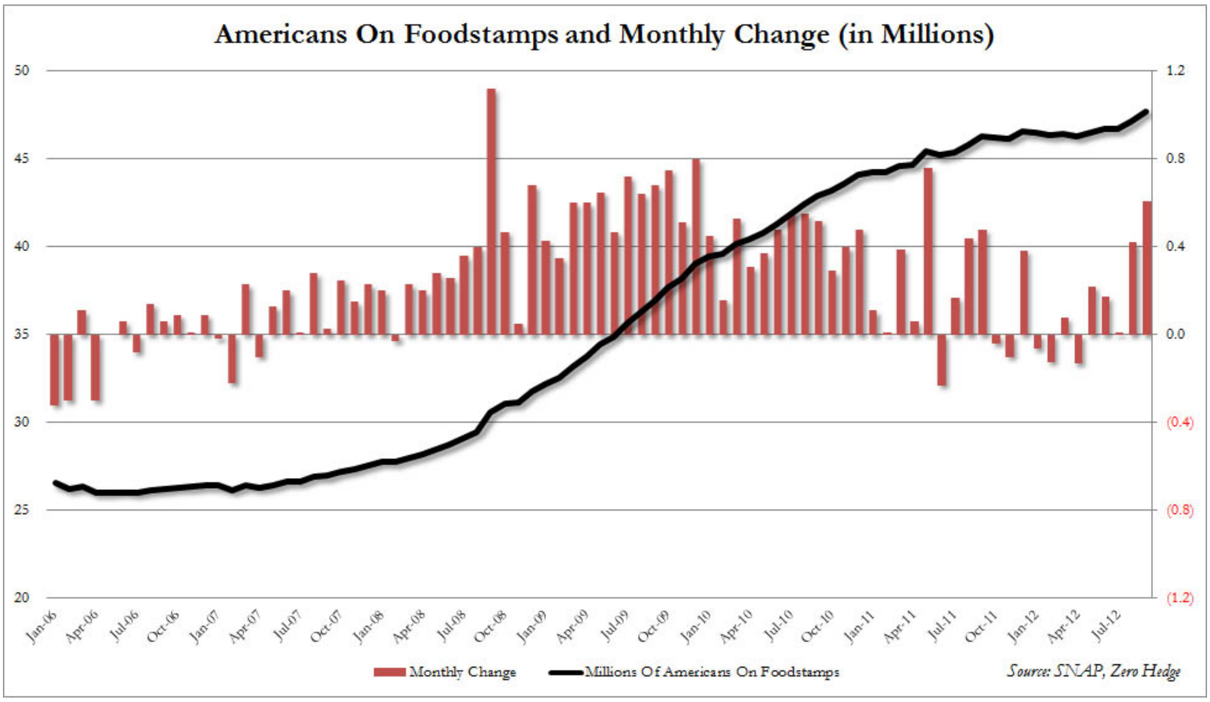
During the quarter CI's investment team travelled to the US visiting companies across a large spectrum of industries including telecommunications, utilities, FMCG, retail, paper manufacturing and IT. Some of the key insights included:

- The current market dynamics in the US mobile market are extremely attractive with an oligopoly market structure and strong monetization of the voracious appetite for data usage resulting in strong revenue growth and margin expansion across the industry. While this trend is yet to play out to the same extent in the Australian market, we believe that the market structure and dynamics have never been more attractive and there is the potential for upside to revenue and margins.

- There appears to be an evolving investment category of companies in consolidating low-growth industries in developed markets that is producing some interesting investment opportunities. A meeting with Rock-Tenn highlighted the attractive dynamics in the US containerboard market with the market consolidating amongst a handful of rational players and they are starting to see some fairly significant pricing power. Additionally, given that these industries are "ex growth" they tend to be "ex-capex" and are thus producing significant amounts of free cash flow.

- There is an emerging 3rd world country in the US with 30% of the population unable to access any form of traditional bank credit. There is a net migration of the US middle class into the lower class with the number of Americans on food stamps (a $134.29 average monthly benefit) swelling from ~25m in 2007 to a staggering 47.7m in August 2012 (i.e. over 15% of the population are living in absolute poverty!) While there are likely to be significant longer term social problems from this trend, it is currently providing a tailwind to a range of industries including non-traditional credit providers such as pawn shops and cheap fast food outlets.

DECEMBER 2012




While the consumption and the "I want it now" culture is alive and well in the US, consumers are being restricted by the extremely tough credit standards being imposed by the banks. It is difficult to see a fully-fledged consumer recovery without credit standards relaxing given that real wages are going sideways.