COOPER INVESTORS ENDOWMENT FUND
QUARTERLY COMMENTARY REPORT

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

SEPTEMBER 2020

	**PORTFOLIO	#BENCHMARK	VALUE ADDED
ROLLING 3 MONTH	-0.54%	-0.08%	-0.46%
ROLLING 1 YEAR	-4.30%	-9.22%	4.92%
ROLLING 2 YEAR	3.50%	1.87%	1.63%
ROLLING 3 YEAR	8.37%	6.25%	2.12%
ROLLING 5 YEAR	8.83%	8.83%	0.00%
SINCE INCEPTION*	9.00%	7.05%	1.95%
SINCE INCEPTION^	76.31%	56.57%	19.74%

*Annualised
^Cumulative (3 March 2014)
**Before fees and expenses and adjusted for franking credits
#S&P ASX200 Accumulation Index – adjusted for franking credits

The purpose of the Cooper Investors Endowment Fund (the "Fund") is to provide a conservative equities portfolio that may be suitable for investors who are in the pensions/decumulation phase. The portfolio may also be suitable for charities, foundations and others who are looking for a conservative equities exposure.

Whilst return is important the portfolio also aims to perform much better in down markets and to exhibit lower than market volatility.

The Fund commenced in March 2014. Over the ensuing six years the portfolio has achieved its objectives of delivering a higher return than the market with a lower level of risk. These objectives have been achieved through stock selection and portfolio construction. The strategy is unchanged since the commencement of the Fund.

Market and Portfolio Performance

The ASX 200 Accumulation Index (adjusted for franking credits) returned -0.1% over the September quarter and over the last 12 months returned -9.2%. The model Endowment Fund portfolio returned -0.5% and -4.3% for the quarter and year respectively.

The ASX 200 Accumulation Index ended the quarter down 0.4% after falling 3.7% in September, which was the first down month since March. Investors were concerned that global growth could slow without further stimulus, exacerbated by the upcoming US election and its potential for delaying this stimulus given the risk of a contested outcome. Adding to the risk-off in markets for September was the flare up in Covid cases in Europe and the risks of a second wave of infections and deaths.

In Australia, the economic recovery slowed after Victoria went into stage 4 lockdown. However, similar to other countries around the world, significant government stimulus continued to support a recovery in economic activity from the March/April nadir. The October 2020 budget also offered further stimulus measures, in particular to help support business, with government debt now expected to well exceed one trillion dollars sometime during the next few years.

Stocks that performed well over the quarter included **Chorus (CNU)** (increased confidence in dividend growth profile), **ARB Corporation (ARB)** (earnings much better than feared and the trend to

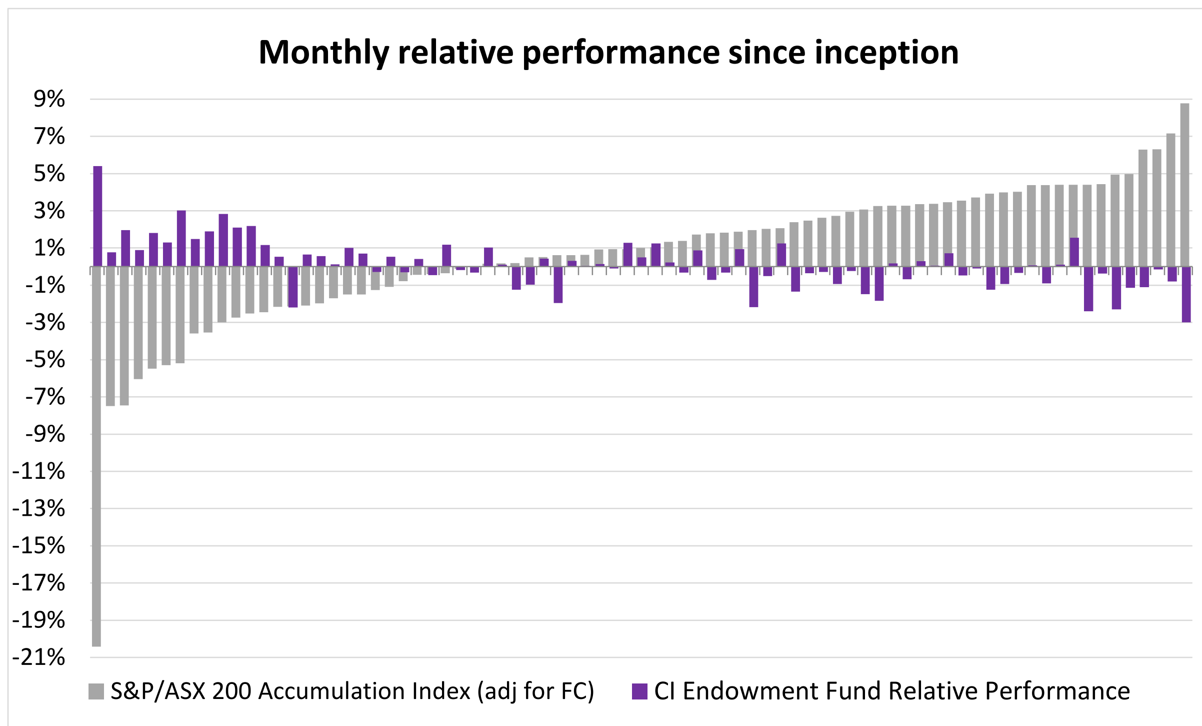
local tourism/travel), **Danaher Corporation (DHR)** (stronger than expected earnings), and **Mainfreight (MFT)** (solid FY20 result and cautiously optimistic outlook).

The poor performers for the June quarter included **Insurance Australia Group (IAG)** (weak FY20 result and ongoing industry headwinds), **Qube (QUB)** (economic softness will likely impact earnings in FY21), and **Ampol (ALD)** (refinery weakness and lack of clarity around capital allocation).

The international stocks in the portfolio (8 stocks, 16% of the portfolio) performed very well over the quarter, particularly Danaher and Costco, even with almost a 4% headwind from an appreciating A$/US$.

The volatility of the portfolio over the quarter was 73% of the market's volatility.

The chart below shows the Fund's monthly relative returns. The grey bars show each month's market return sorted from the worst to best month and the purple bars show the portfolio's return relative to the market for each month.



Since inception the market (adjusted for franking credits) has shown a monthly negative return 30 times and in these months the portfolio has performed better than the market 24 times (80%). When assessed using monthly data the portfolio has captured 69% of the market's downside and 86% of the market's upside.

The Portfolio

During the quarter we added Resmed, Franco Nevada and Yum China to the portfolio and increased our position in BHP.

We sold our remaining holdings in Sydney Airport, Amadeus IT Holdings and Carindale Property Trust given the headwinds facing both the retail and air travel industries are proving to be more protracted than originally anticipated at the outset of the pandemic.

We also exited Rio Tinto following the significant controversy around their destruction of the Juukan Gorge caves in 2020. This has resulted in substantial reputational damage that in our view will weigh on the company's outlook until there is demonstrable improvement in governance of these issues.

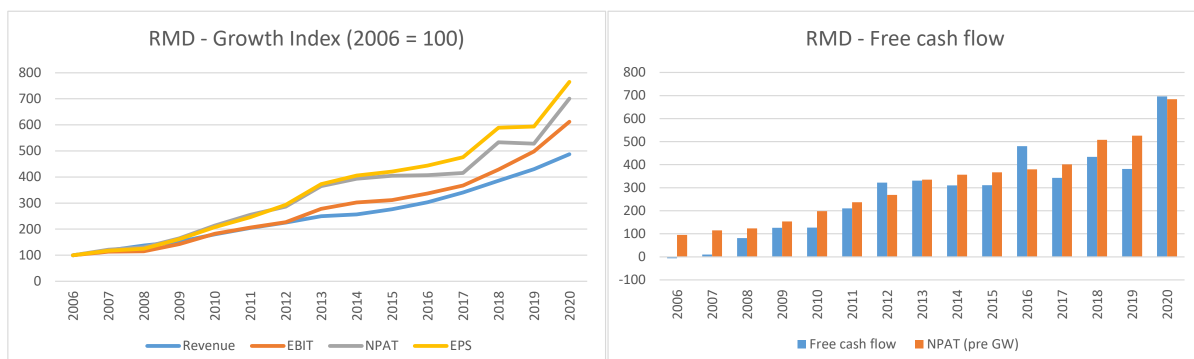
Resmed (RMD) has been on our watchlist for some time and following some mixed outlook commentary in RMD's 4Q results release the share price sold off from just above $29 to around $25, which we viewed as an opportunity to initiate a position in this high quality healthcare business.

The company is a leader in sleep disorder therapy (sleep apnoea) industry, which enjoys tailwinds from a large unmet need with estimates that only 26% of people with sleep apnoea have been diagnosed, of which only a small proportion receive treatment (estimate around 20%).

RMD has more recently expanded into the out-of-hospital SaaS industry via an acquisition-led strategy. The SaaS opportunity is large with an estimated US$1.5b revenue pool compared to current RMD SaaS revenues of US$355m, and over time has the potential to drive further sales of core RMD products.

The company's track record is very good, backed by strong management credentials, noting that the Chairman (Peter Farrell) is the founder and his son (Mick Farrell) is CEO. The economic engine of the business is robust with a history of double digit top line growth, EBITDA margins >30%, and 20%+ ROFE demonstrating the company is able to reinvest at good rates of return.

Earnings quality and financial quality are excellent with strong cash conversion, ND/EBITDA of 0.7x, and the company has generated on average US$500m pa of free cash flow over the last five years. Dividends commenced in FY12 and while the dividend yield is low at ~1% (unfranked), DPS has grown from US$0.76 in 2013 to US$1.56 in 2020 or a 10.8% compound annual growth rate.



Source: Company data, Diogenes Research

RMD also has positive responsible investing credentials given its products slow chronic disease progression, reduce overall healthcare system costs and improve patients quality of life.

So in summary, RMD improves the Fund's diversification and increases exposure to the healthcare industry which has attractive long-term growth prospects and a resilient earnings and dividend profile.

During the quarter we added **Franco Nevada Corporation (FNV)** to the portfolio. FNV's roots go back to the early 1980s when Pierre Lassonde founded the original Franco-Nevada. After being acquired by Newmont in 2002 the Franco-Nevada team continued to manage royalty assets as part of Newmont Capital.

In 2007, Newmont offered a package of many original Franco-Nevada royalties along with other royalties for sale. The original Franco-Nevada team incorporated a new Franco-Nevada, launched an initial public offering (IPO) and on December 20, 2007 acquired the royalty portfolio for $1.2 billion.

FNV is a gold-focused royalty and streaming company which owns and continues to grow a large, diversified portfolio of royalty streams which expose it to the long-term exploration and price optionality inherent within their asset portfolio.

Part of the attraction of FNV is that it doesn't have the risk of a miner or explorer, being exposure to operating or cash calls, although it does have exposure to production risk. Simply put, FNV provides investors with gold price and exploration optionality with less exposure to operating risks. It uses its' strong free cash flow to expand its portfolio and pay dividends.

		Gold ETF	FNV	Operators
Limited Exposure to:	Capital Costs	✓	✓	X
	Operating & Other Costs	✓	✓	X
Benefit of:	Leverage to Gold Price	X	✓	✓
	Exploration & Expansion	X	✓	✓
	Dividend Yield	X	✓	✓

Source: Franco-Nevada

There has been some management transition recently but this has been handled well. New CEO Paul Brink is replacing David Haruqail who will become Chairman, noting both Paul and David have been with FNV since its IPO in 2007. Pierre Lassonde (founder) has taken on the title of 'Chair Emeritus'. The tight-knit management team at FNV has been together for a long time and is a key attribute of the investment proposition.

FNV has benefited from strong appreciation of the gold price as well as operating performance which has delivered 80% EBITDA margins, free cash flow conversion (vs NPAT) of over 100%, and a fortress balance sheet that is CAD210m net cash. The company's exemplary track record is reflected in the chart below highlighting its compound annual returns since inception.

Compounded Annual Returns Summary

	1-Year Total Return	2-Year Total Return	5-Year Total Return	Since FNV Inception
Franco-Nevada - US$ basis	60.4%	30.8%	21.2%	19.9%
Gold Bullion ETF	29.5%	11.6%	7.1%	5.8%
GDX	37.5%	16.3%	10.3%	(2.4%)
TSX Composite	3.7%	5.2%	4.7%	4.6%
S&P 500	9.4%	6.5%	9.7%	8.3%
NASDAQ	15.5%	9.1%	13.0%	11.4%
Barclays US Aggregate Bond	13.6%	8.4%	4.2%	4.5%
Vanguard Total World ETF	3.9%	1.2%	6.1%	5.7%

1 FNV Inception - December 20, 2007 Compounded annual total returns to March 6, 2020 Source: TD Securities; Bloomberg

Source: Franco-Nevada

The dividend yield is 0.7% (55% payout ratio) which should grow at low single digit rates in line with cash flow from current producing assets, with upside risk from exploration assets coming into

production. The dividend has increased for 12 consecutive years highlighting the secure nature of the income stream.

At current gold prices we estimate FNV is around fair value which seems reasonable for a very high quality gold exposure with significant value latency embedded in the non-producing portfolio that we are getting for free at the spot gold price.

From a portfolio construction perspective the key point to note is that gold has low correlation to equities markets but, more importantly, during large market drawdowns there is often inverse correlation which increases downside protection. Gold can also provide a hedge against low inflation, disinflationary or even deflationary environments. Our analysis shows that FNV significantly improves diversification and lowers correlation as it is inversely correlated to most stocks in the portfolio.

The Fund initiated a position in the Hong Kong listing of **Yum China (YUMC)** during the quarter. YUMC is the largest restaurant group in China operating almost 9,000 restaurants (of which only 9% are franchised) including over 6,000 KFC's and over 2,000 Pizza Huts.

YUMC was fully spun off from YUM! Brands in November 2016 and pays a 3% royalty fee on system revenues to its former US parent, in return enjoying exclusive rights to use those brand names in China. Whilst on the surface YUMC appears to be "just another Master Franchise" our research process highlighted that over YUMC's 32-year history they developed an owner-operator culture distinct from YUM! Brands and distinctly Chinese.

This has allowed YUMC to create a highly localised customer proposition benefitting from a strong local appetite for chicken and to become the clear market leader. Released from the shackles of a distant decision-maker we observe that YUMC have succeeded in developing an agile and entrepreneurial philosophy that has resulted in richer and deeper IP than YUM! Brands. This is particularly evident in areas like Menu Innovation and Digital (over 95% of KFC transactions are completed digitally) where they are arguably now the global leaders.

KFC is the key value driver for YUMC, representing ~70% of units, ~90% of profits and given KFCs highly attractive new unit economics, 90% of new units. When most people in Australia think of KFC they typically picture a big bucket of fried chicken. Yet KFC in China has a far broader menu that caters to local tastes, such as serving Congee during the breakfast daypart and localising taste profiles to suit regional palates, such as spicier recipes for Sichuan province.

In addition, KFC regularly create new dishes to stoke consumer demand or adjust to price changes. A recent example of innovation and flexibility was switching to duck wraps and mushroom burgers to offset soaring chicken prices which were indirectly affected by African Swine Flu. YUMC have navigated this significant supply chain event with negligible margin erosion.

Management have several exciting value latencies to execute including new KFC roll outs, improvement of Pizza Hut margins and development of new formats. In addition to growth opportunities a net cash balance sheet and strong cash flow profile means YUMC can provide attractive and growing distributions (currently ~3% combined dividend and buyback).

YUMC is an underappreciated Chinese Stalwart given a stable, simple and cash generative business model run by a highly driven owner-operator culture. YUMC also benefits the portfolio by increasing exposure to China and lowers the correlation of the portfolio stocks.

The portfolio owns 37 securities including eight global stocks (16%) and three New Zealand stocks (8%). The cash weighting is around 5%.

Stock News

During the quarter, **Ampol (ALD)** announced the establishment of an unlisted property trust that will hold 203 freehold Convenience Retail sites. A Charter Hall and GIC consortium will acquire a 49% minority interest in the trust for $682m with Ampol retaining a 51% controlling interest. The trust will receive approximately $77m in rental payments from ALD in the first year (100% basis) and the transaction, which reflects a cap rate of 5.5% and values the entire property trust at $1.4bn, is expected to close by the end of 2020. Whilst it is pleasing to see ALD begin to unlock the latent value across the asset base, the transaction is of smaller scale than previously outlined to the market (203 sites as opposed to 250 sites). With ~230 freehold property sites remaining 100% owned by ALD post transaction, we would encourage further monetisation across the portfolio.

Although we recognise that the heightened levels of uncertainty in the very short term require some degree of prudence, we believe flexibility around capital management frameworks need to be exercised in a manner that both delivers value to shareholders and takes advantage of market opportunities when they arise. In this case, with net debt / EBITDA towards the lower end of management's 1.5-2.0x target post completion of the property transaction, we were disappointed with the lack of intent shown in recent announcements to return capital to shareholders. With two large Hybrid issuances in the market in recent weeks (Scentre Group (A$4.1bn) and AusNet (A$650m)), we would encourage ALD to execute on the A$300-500m hybrid issuance proposed in late 2019 and begin the process of distributing the significant franking credit balance (~$3ps) to shareholders.

Initially, when the pandemic hit, **ARB Corporation (ARB)** was negatively impacted by forced shutdowns in many of its key geographic regions. Subdued and uncertain consumer demand led to a significant fall in ARB's order book and the need to scale back manufacturing, reduce operating and capital expenditure, preserve cash and secure liquidity sources.

As the global response to the pandemic stabilised, ARB's order book recovered strongly in June and July, both record months for the company. In some ways, the pandemic has now become a tailwind for ARB, with many consumers unable to spend on international travel and other discretionary items, spending has diverted for example into products related to travel/holidays. Therefore, even despite challenges still in Australia with Victoria in stage 4 lockdown, ARB recently reported a strong Q1 2021 sales growth of 17.7% (versus Q1 2020), underpinned by export market growth.

In addition to an ongoing recovery and growth in domestic operating trends as Victoria reopens, we still see latent value in ARB continuing to grow across its export markets and original equipment manufacturers over the medium term. ARB has a conservative financial structure (net cash balance sheet), yet with a willingness to take calculated risks over the years.

Chorus (CNU) had a volatile quarter as a number of announcements were provided to the market relating to the regulatory determination of CNU's new ultra-fast fibre broadband (UFB) network. These regulatory settings will be critical to setting the regulated asset base (RAB), WACC and therefore the maximum allowable revenue (MAR) the company is allowed to earn on the UFB. This will determine the free cash flow generated once the fibre network rollout is completed and ultimately the dividends CNU will be able to pay to investors. So far there have been both positive and negative changes suggested as part of this process and we are mindful there is still some way to go as we move towards regulatory clarity with the new regime scheduled to be introduced from 1 January 2022.

Importantly CNU also announced that it will transition to a free cash flow based dividend policy from FY22, which we expect to lead to a step change in dividends in FY24 once the residual communal capex is completed for the UFB2 rollout in FY22 and FY23. Preliminary estimates suggest CNU should be able to increase distributions from the forecast NZ25cps in FY21 up to NZ50-60cps from FY24. This allows investors to increasingly focus on the medium-term dividend trajectory which is increasingly valuable in a low interest rate environment.

CSL Limited (CSL) made two important announcements in October. Firstly, Joy Linton will be appointed as CFO and will be based in CSL's head office in Melbourne. Joy most recently held the position of CFO at Bupa, the global health insurance company based in the UK. Joy brings to CSL more than 30 years of experience in complex, highly regulated businesses across healthcare and other industries which we think will be highly relevant to CSL. Joy replaces David Lamont who left CSL to take on a CFO role at another large ASX listed company, and we wish David well after almost five years of commendable performance at CSL.

Secondly, CSL announced it had finalised an agreement with the Commonwealth of Australia to supply 51 million doses of the University of Queensland-CSL COVID-19 vaccine candidate (C451), should clinical trials be successful. CSL also has a signed Heads of Agreement with Astra-Zeneca for the expected manufacture of approximately 30 million doses of the Oxford University vaccine candidate AZD1222, following successful clinical trials.

Insurance Australia Group (IAG) announced that Nick Hawkins (IAG CFO) was being appointed as CEO to replace Peter Harmer. Nick joined IAG in 2001 and has spent the last 12 years as CFO and prior to that he spent two years as the CEO of IAG's New Zealand business. Nick is a highly experience insurance executive that will officially take up the role in November when Peter leaves the company after 5 years as CEO.

In September **Seek (SEK)** shares rallied on speculation that Alibaba may invest in Zhaopin (Seek's China business), to which Seek replied Zhaopin are in discussions with a number of parties to assess whether new investors would support Zhaopin's long term strategy (or in other words, not denying the speculation). This followed Zhaopin's competitor 51Jobs getting a non-binding takeover proposal from private equity firm DCP Capital Partners. In our view these announcements serve to highlight the attractiveness of the China online classifieds sector that SEK has exposure to via its investment in Zhaopin.

The a2 Milk Company (A2M) provided a weak trading update mainly due to a sharper slowdown than expected in the daigou channel in September as a result of the stage 4 lockdown restrictions in Victoria. Management anticipate the daigou disruption will continue for the remainder of the first half of FY21 which will significantly impact the Australia & New Zealand business with revenue expected to be materially below budget.

However the company also noted the underlying consumer demand for their brand in China remains strong and that this is a single channel logistics issue and therefore temporary in nature. Notably, other fundamental factors remain positive such as 77% sales growth in the Mother & Baby Stores channel and solid performance in the cross-border e-commerce channel.

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