Cooper Investors Global Equities Fund (Unhedged)

COOPER INVESTORS

QUARTERLY COMMENTARY | SEPTEMBER 2023

AFS LICENCE NUMBER 221794 ABN 26 100 409 890

"In theory there is no difference between theory and practice – in practice there is". – **Yogi Berra**

"It's easier to fool people than to convince them that they have been fooled." – **Mark Twain**

	**Portfolio	#Benchmark	Relative
3 months	-0.48%	-0.37%	-0.11%
1 year	19.76%	20.34%	-0.58%
3 year*	6.65%	10.70%	-4.05%
5 year*	7.93%	8.92%	-0.99%
7 year*	10.46%	11.27%	-0.81%
10 year*	11.42%	11.62%	-0.20%
Since inception*	8.97%	8.68%	0.29%
Since inception^	265.12%	250.79%	14.33%

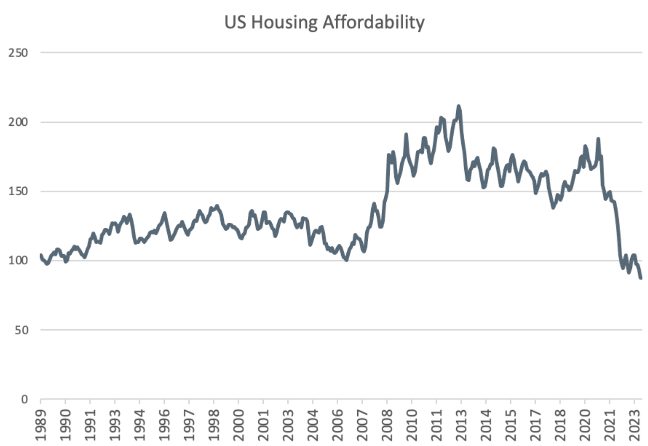
* Annualised
^ Cumulative (since inception on 1 September 2008).
# MSCI AC World Net Divs in Australian Dollars.
** Net of fees and expenses.
Past performance is not a reliable indicator of future performance.
Data Source: Internal CI data reports, 30 September 2023

COMMENTARY

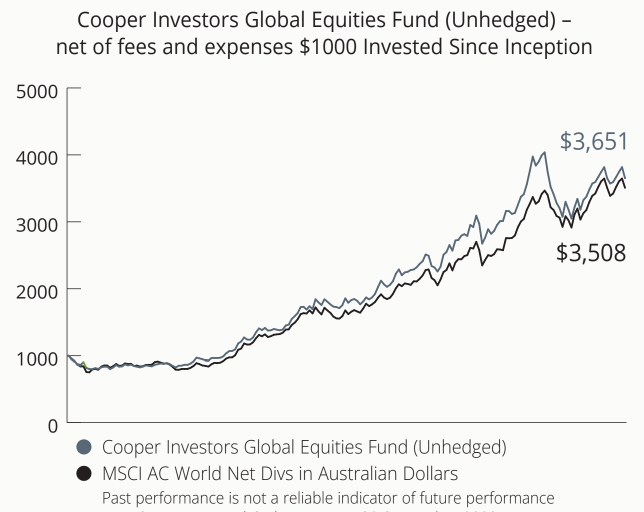
The market has been playing out an echo of early 2022 with oil prices up, rising bond yields, a strong US dollar and equity markets retreating accordingly.

Further OPEC supply cuts early in the quarter saw crude prices gain 30% feeding concerns that higher energy prices will keep inflation elevated. This was exacerbated by recent central banker language striking a 'higher for longer' tone, suggesting that while rates may be close to peaking, persistent sticky inflation will necessitate restrictive policy for longer than expected.

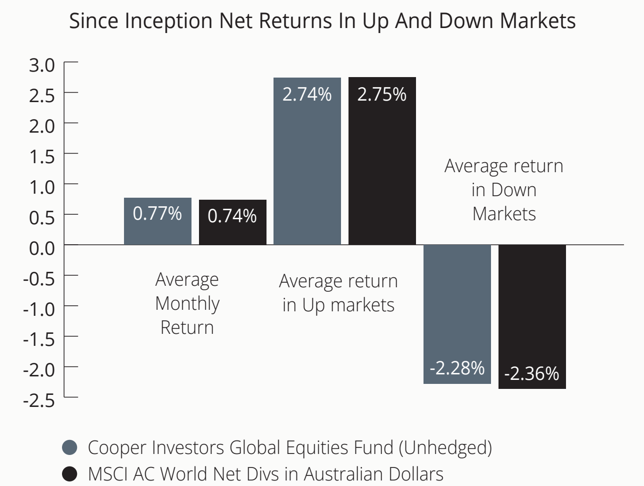
With rate cuts in the US pushed further out the yield curve steepened with 10-Year yields hitting 4.8% just after quarter-end, a 16-year high. Annual returns on the 10-Year Treasury bond are on track for a third straight year of losses which has never occurred in 250 years of US history (per Bank of America). 30 Year mortgages are now 8%, driving implied housing affordability to its lowest level for many decades.



Source: National Association of Realtors.



Past performance is not a reliable indicator of future performance
Data Source: Internal CI data reports, 30 September 2023



Past performance is not a reliable indicator of future performance
Data Source: Internal CI data reports, 30 September 2023

All of this seems rather worrisome, but the US is still not (yet) in a recession. As noted in our prior quarterly, a quirk of the US 30-Year fixed mortgage market means that while new mortgage rates are dramatically higher than two years ago, most existing homeowners remain on relatively lower rates, delaying the transmission of rate hikes into higher mortgage repayments we see in the UK or Australia.

In September we spent time in Texas (see Trip Notes for further detail) where we conducted several housing related meetings including a large national home builder, a building materials distributor, and toured a new housing development under construction. Home builders have seen remarkably strong operating trends as inventory of existing home sales remains at historically low levels. Residents are reluctant to move house and reprice a mortgage from ~3.5% to double that so the only option for families moving to a city like Houston is to buy new. National home builders are aggressively offering subsidised finance ('mortgage buydowns') which reduces rates by around 1%.

It was reiterated to us that the most important factor in housing remains jobs, and for now the employment outlook remains reasonable. With jobs still plentiful and a less direct impact onto consumer hip-pockets, the demand destruction of monetary policy is taking longer to bite in the US, observable in the resilience of US consumer spending throughout this year.

This is not the case everywhere with some central banks commencing rate cuts during the quarter in the face of weaker leading indicators. As is often the case with contagion of economic stress from the core, cracks show first in the periphery. The cutting trend has begun in emerging markets across Latin American (Brazil cut 50bps in August and September), Eastern Europe (Poland cut 75ps in September) and most notably China (cut one-year loan prime rates another 10bps in August).

Regarding China, global investor sentiment has soured further in recent months. The implosion of the commercial real estate market hit headlines again as the founder of a large property developer was detained by police. Our experience suggests Value Latency may emerge when markets are labelled 'uninvestable', as China now is for many. We see this today with our investment in **Yum China**, a consumer Stalwart that owns and operates KFC and Pizza Hut locations in the country.

Quick service restaurant chains can be great wealth creators and are favoured by investors attracted to compounders that generate enduring returns on capital. The listed players often trade on handsome premiums to market multiples which can be particularly rich earlier in the roll-out story when the business is rapidly opening new locations as well as growing same store sales. Consider Chipotle Mexican Grill, a US-listed chain of Mexican fast-food restaurants (not owned) with around 3,400 stores that has an enterprise value of US$50bn and typically trades at an implied earnings multiple in the high 30's.

We are accustomed to consumer rollout stories in Asia trading at eye-watering valuations, yet with the negativity swirling around China today there is material Value Latency with Yum China trading on an enterprise value of ~US$20bn and a multiple of earnings ~20 times. The business operates around 13,500 stores and incremental unit economics on new stores are among the best we've seen globally in the QSR space, with payback periods on small formats even quicker. Management did a good job navigating the brutal COVID period. With that behind them, the future looks bright and underappreciated by the market.

CEO Joey Wat presented their 2023 Investor Day in Xi'an during the quarter, announcing an increase in the pace of store openings to ~1,800 a year (from ~1,300). This includes KFC, Pizza Hut, and other brand concepts like Lavazza coffee stores which has already grown to over 100 outlets across 11 cities since launching in 2020.

If they execute on this opportunity the business is likely to grow revenues in the mid-teens over the next three years. With buybacks of around US$3bn by 2026 the organic growth, combined with reduced share count, should translate to earnings per share growth in the high-teens or even low-twenties percent. If that still doesn't whet the appetite for fried chicken, add a 1% dividend on top.

PORTFOLIO PERFORMANCE

The portfolio returned -0.48% in the quarter, versus the benchmark return of -0.37%.[1]

Rising bond yields, higher energy prices and a strong dollar is typically unfriendly for equities and indeed global stocks gave up early gains in July to close markedly weaker into quarter end. Energy was the only sector in the entire index to be up in September. The AUD fell 3% versus the US dollar, softening the blow to unhedged investors.

In early 2022 this kind of environment was particularly challenging for the fund, this time around the portfolio proved far more resilient with positive absolute returns in Stalwarts and Asset Plays more than offsetting a derating in some Growth and Cyclical investments.

1. Past performance is not a reliable indicator of future performance

Cooper Investors Global Equities Fund (Unhedged)

COOPER INVESTORS

QUARTERLY COMMENTARY | SEPTEMBER 2023

AFS LICENCE NUMBER 221794 ABN 26 100 409 890

The 2023 concentration of benchmark returns has largely persisted; while some tech heavyweights did underperform this quarter, the state of play continues to be that the NASDAQ is +25%, the S&P is +10%, S&P Midcaps are flat, and the Russell 2000 is -2% for the year so far.

The biggest contributors to portfolio return in the quarter were **Booking Holdings** (rebound in travel), **Arthur J Gallagher** (pricing and capital environment still good for insurance brokers), and **Scout24** (solid execution from management in revenue growth and upgraded earnings targets is beginning to be recognised).

The biggest detractors to return in the quarter were **Adyen** (H1 results saw recent growth and margins miss expectations), **HDFC Bank** (volatility as the merger with HDFC Ltd closed and the market absorbed new estimates for combined entity) and **Ulta Beauty** (gave up June gains as US consumer stocks lagged).

THE PORTFOLIO

With the market rally in the first half of 2023 driving double digit returns we took the opportunity early in the quarter to reassess Value Latency embedded in the portfolio. The spotlight was on more highly valued stocks that represent some of our longest held positions and among the better performers over the years. The outcome is that we have exited several long-term positions at what we consider attractive prices, where the balance of Risk Adjusted Value Latency was no longer in our favour.

We remain admirers of these businesses and they remain on our watchlist, but the reality is their appeal is widely recognised today. Management have executed well on earnings growth, but returns have also come from substantial multiple re-ratings that we see as unlikely to reoccur from today's higher base.

- **Costco** was acquired in March 2015 at ~$150 and has more than tripled over its holding period to ~$550 today, delivering a total return with dividends reinvested of ~330% in USD or IRR of 20%. Over the journey the multiple re-rated from 25 times to ~35 times.
- **Halma** was invested in October 2015 at ~£7.50 and nearly tripled to our exit price of ~£22, a total return with dividends reinvested of ~210% or IRR of 15%. The multiple has rerated from 23x to almost 30x at exit.
- **Unicharm** was bought at JPY3,200 and sold for around JPY5,200, a return of ~70% in local currency with dividends reinvested or IRR of 11%. The multiple has grown from 30x to ~36x.

The capital was reinvested into existing holdings where Value Latency is plentiful. Stock names are now down to 38.

The portfolio is positioned around Subsets of Value.

- **Stalwarts** (46% of the portfolio) – sturdy, strong and generally larger companies with world class privileged market and competitive positions (Aon).
- **Growth companies** (18%) – growing companies with identifiable value propositions using traditional value metrics and run by focused, prudent and experienced management (Eurofins).
- **Bond like equities** (3%) – stocks with secure, low-volatile dividends that can be grown and recapture inflationary effects over time (Ferrovial).
- **Low risk turnarounds** (7%) – sound businesses with good management and balance sheets. (APi Group).
- **Asset plays** (5%) – stocks with strong or improving balance sheets trading at discounts to net asset value or replacement value (Sony Corp).
- **Cyclicals** (17%) – stocks showing both upside and downside leverage to the cycle with experienced and contrarian managers who allocate capital prudently (Ferguson).

The portfolio is also diversified by Clusters of opportunity.

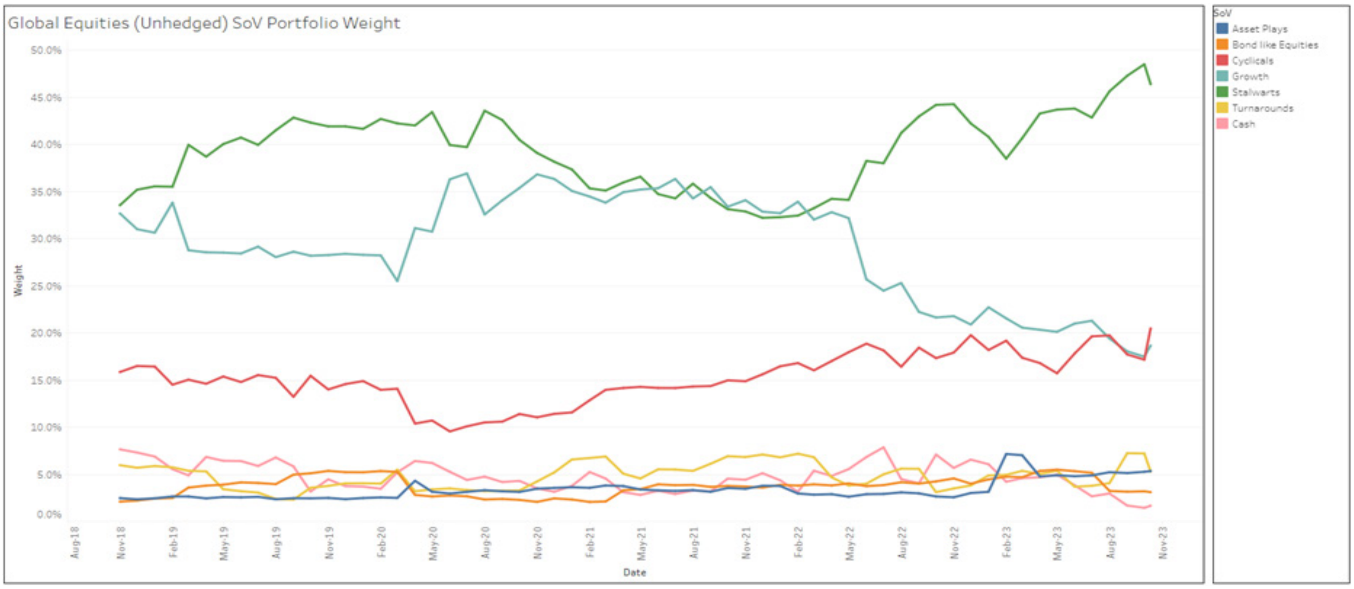
- **Digital Ecosystem** – Payments, SaaS, Marketplaces, Content (Scout 24, Salesforce, Sony)
- **Niche Industrials** – Business Services, Manufacturers, Distributors (Rentokil, Ferguson)
- **Emergent Consumer Growth** – Discounters, FMCG (B&M, Haleon)
- **Broker Models** – Insurance, IT Resellers, Financial Brokers (Aon, CDW)
- **Physical Infrastructure** – Toll roads, Airports, Towers, Rail (Ferrovial, Liberty Broadband)
- **Life Sciences** – Diagnostics, Testing, Services (Danaher, IQVIA)
- **Data, Analytics & Exchanges** – Datasets, Tools and Financial Plumbing (LSEG, RELX)
- **Semis** – Semis and Production Equipment (Tokyo Electron, TSMC)

Cooper Investors Global Equities Fund (Unhedged)

COOPER INVESTORS

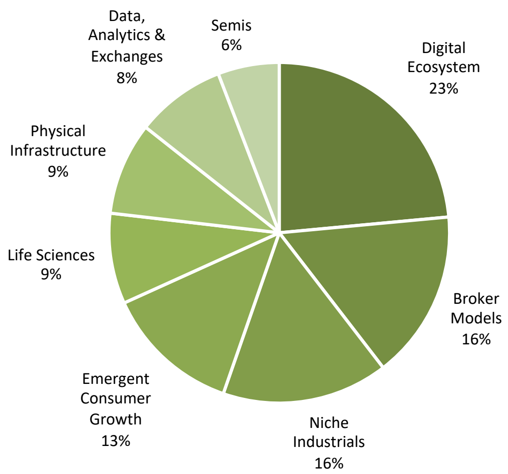
QUARTERLY COMMENTARY | SEPTEMBER 2023

AFS LICENCE NUMBER 221794 ABN 26 100 409 890



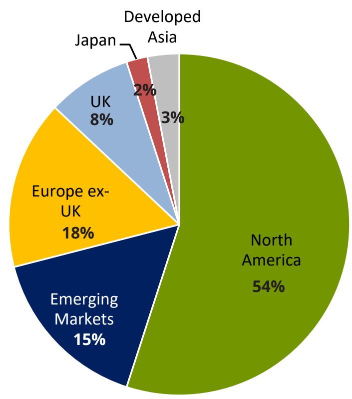
Source: CI Internal Data

Portfolio by Cluster



Source: CI Internal Data

Geographical Exposure by Source of Revenues#



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

Source: CI Internal Data

No. of Stocks	38
Region Weights (by listing)	North America 54%
	Europe 26%
	Asia 12%
Most OW Sectors	Financials, Industrials
Most UW Sectors	IT, Energy
Cash	1%

Source: CI Internal Data

Portfolio Metrics – Weighted Average	
Price to Earnings [1]	19.4x
Price to Free Cash Flow [1]	19.4x
Net Debt to EBITDA [1]	1.17x
Return on Equity [1]	25.1%
Revenue Growth [2]	8.3%
Earnings Growth [2]	15.4%
Total Cash Yield [2, 3]	2.4%

1 Next twelve months forward
2 Estimated, FY1 to FY2
3 Estimated, dividends plus buybacks

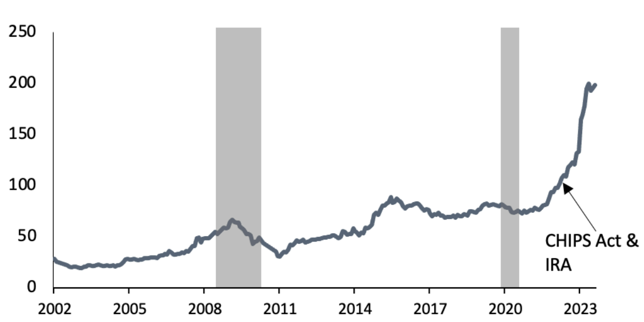
Source: CI Internal Data

STOCK NEWS

Two recent additions to the portfolio are **United Rentals** (URI) and **Ashtead Group** (AHT). URI and AHT are the two largest equipment rental businesses in North America, serving non-residential construction and general industrial (MRO) markets. They offer thousands of products ranging from forklifts, scissor lifts and mobile cranes to small loaders, excavators, and air compressors. While fitting into our Cyclical subset, these businesses have an enviable history of generating attractive returns on invested capital and we see significant growth opportunities ahead.

Observable trends in the equipment rental sector are favourable. The industry is relatively young and continues to evolve into an attractive, more consolidated industry structure. URI and AHT are by far the largest two players in their industry and are growing at above market rates. There is a virtuous benefit to scale in this industry, driven by procurement advantages on equipment, better equipment availability and more opportunity to invest in technology that improves service levels.

The other key observable industry trend is the nascent reindustrialisation and rebuilding of essential infrastructure in the US. Over the last 30 years there has been significant disinvestment in the US in both areas. This now appears to be turning a corner, driven by a multitude of factors including government action, corporates reassessing supply chains post-COVID (so-called 'deglobalisation') combined with heightened geopolitical tensions. The chart below shows a meaningful uptick in manufacturing construction spending in the last two years. Importantly the uptick in overall construction spending for both private non-residential structures and public infrastructure spending is coming off a low base relative to history.



Source: FRED Economic Data

Management at both URI and AHT have proven track records when it comes to operational execution and disciplined capital allocation. CEOs Matt Flannery at URI and Brendan Horgan at AHT both have multiple decades experience in the industry and at their respective companies. We think this is an important attribute given the pronounced cycles the equipment rental industry tends to go through.

The growth opportunity ahead for both businesses remains significant. The rental industry continues to outgrow its end markets driven by conversion from ownership to rental and the end markets themselves have positive observable trends. Beyond that URI and AHT can continue taking market share from the long tail of smaller operators in their industry. This market share gain is potentially accelerating, for example at the 'megaproject' end of the spectrum where the required scale and know-how means URI and AHT are over-indexing wallet-share wins in these large multi-year jobs.

Despite being exceptional value creators over many time periods, both URI and AHT trade at reasonable valuations today. They run conservative balance sheets and tend to have countercyclical cash flow profiles. We think some of the Value Latency on offer comes from a misconception about the proposition a scaled equipment rental business brings to customers, perhaps viewed as outsourced capital providers rather than a value-added service. The long-term unlevered return on capital profiles of these businesses provides a good clue to the level of value-add URI and AHT provides.[2]

TRIP NEWS

During the quarter the team travelled across the US and Canada, visiting nine cities across six US states and two Canadian provinces. The schedule was heavily focused on asset tours, in which we spent multiple days touring operations across several portfolio holdings. These were bespoke itineraries with no other investors present, reflecting the trusted network building effort that is a critical part of the CI process.

We spent a significant amount of time in Texas, which is an area of relative economic strength compared to the rest of the US. Texas continues to grow, with people arriving from Northern coastal cities in their droves. Net migration of Dallas plus Houston is around 200k – for context that means two cities in Texas have move migrants arriving than the entirety of Australia (2022 net overseas migration of 170k). Within the state 'North Texas' (effectively the counties of Dallas and Tarrant) represents a pocket of extreme growth and is the #1 fastest growing region in the US. A few stats from a recent North Texas Commission publication:

2. Please note this is a forecast only, based on CI's current views and assumptions

- 7.7mn residents growing by 3,000 a week, forecast to grow to 10mn by 2030 (13mn by 2040)
- Job growth of +8% (double the national average)
- HQ for 23 Fortune 500 companies
- If North Texas were a state, it would rank 13th in GDP (between Massachusetts and Virginia)
- If it were a country, it would rank 23rd in GDP (between Sweden and Poland)

The portfolio has exposure to this growth corridor via the toll road assets operated by Cintra, (US subsidiary of portfolio holding **Ferrovial**) in the Dallas-Fort Worth metro area. Our visit covered the traffic management centre as well as driving the roads in Friday afternoon rush hour traffic. We were impressed by the quality of the operations, the experience of local management (long tenured Ferrovial veterans) and the intentionality on display to constantly improve the assets. What we observed during our drive was that in Texas, the land where the car (or more accurately truck) is king, the local propensity to pay is very high.

These roads operate dynamic tolling where pricing fluctuates from a few dollars to north of $25 depending on traffic flow. For heavy goods vehicles there is a 5x multiplier, meaning some of the large trucks we saw were paying over $120 on those segments. Yet the toll lanes can save a contractor an hour getting from one side of the city to another, meaning they can do an extra job or stop on their route that more than compensates for the toll cost. Daily distances travelled are high, so the utility of using tolled lanes at 75mph versus crawling along at 30mph in a general-purpose lane is high.

The major focus in Texas was spending a day visiting operations of **Union Pacific** (UNP), a Stalwart investment made earlier this year.

Our investigations into the railroad industry have felt like a history lesson of the late 19th Century, a peek into the Gilded Age. At this time railroads became a transformative force that connected the East Coast to the Western frontier, pushing the economic potential of US industry and commerce to new heights. Over a century later and despite technological upheaval, the freight railroads of North America still feel just as relevant and a key part of the new industrial age.

To own, operate and invest in a railroad is to be a part of the lifeblood of North America. It is to witness the movement of grain, concrete, steel, wood, energy, autos, and shipping containers across vast distances. These are irreplaceable assets that could not be built today, and for the most part have very few substitutes – UNPs tagline “Building America” certainly rings true.

UNP is North America’s largest publicly listed railroad, both in revenue and route miles. Its network spans more than 32,500 route miles (52,000kms) serving the Western two thirds of the US. It is one of two railroads that access the busiest ports (Los Angeles and Long Beach), connecting them to major population centres in California, the Pacific Northwest, Texas and the Mid-West. It is also the only railroad with six access points into Mexico where autos are moved across the border in staggering volumes. It is the definition of a privileged business within a wonderful industry, structurally, geographically, and financially.

For all its natural advantages, legacy, and history UNP has faced constant risk of stagnation and technology passing them by. The development of interchanges and highway networks, followed by airplane freight, slowly bled volumes from the railroads onto other forms of transportation providing a faster and more reliable service. With volumes waning, railroads exercised their incredible pricing power to grow revenue.

However, over the last fifteen years railroads have revived themselves with innovation in scheduling, technology, and customer focus on carbon emissions where rail has a 75% emission advantage over trucking. But inertia is difficult to shake, and UNP has lagged its rail peers in service and growth for over a decade.

Enter Jim Vena, a lifelong railroader with more than forty years of experience beginning his career in 1976 as a Canadian National labourer, working his way to Conductor, Engineer, Trainmaster, up to Chief Operating Officer under legendary railroader E Hunter Harrison. He was recruited to UNP in 2019 as COO where he oversaw the highest levels of service in the company’s history, yet stayed only two years. Following his departure, service metrics lagged peers, flowing onto mediocre financial performance and recent years have seen investors and activists push hard for change at the top.

In August Jim triumphantly returned as CEO to lead Union Pacific into a new era of operational excellence, injecting the Intentionality and Focused Management Behaviour that has been lacking. We believe this will have a significant impact on financial performance – our thesis is that Jim can light a fire under the railroad.

Our visit included a large sorting yard and multiple intermodal terminals, where we were able to build our knowledge on the complexities and challenges of the operations, as well as spend substantial time with the yard supervisors that run the place day-to-day. We observed numerous latencies within the business ripe to be harvested. Many manual processes can be replaced with automation, labour hours better served in high value tasks rather than rudimentary log keeping, and technology to make the railroad safer and more customer centric. Most encouragingly of all was the pride and passion of the people we met, and their positive attitude to the winds of change that Jim is likely to bring.

In terms of Pattern Recognition, we have observed some of these technological shifts across the Canadian railroads who now lead the way in service, volume growth and financial profile. There is an opportunity for UNP to not only catch up but lead the industry in many of these innovations.