Greencape Wholesale Broadcap Fund

Quarterly report - December 2014

Performance #	Quarter %	1 year %	3 years % p.a.	5 years % p.a.	7 years % p.a.	Inception % p.a.
Fund return	1.81	6.16	17.00	8.81	4.92	9.32
Growth return	0.90	-2.30	11.00	2.70	-0.32	3.56
Distribution return	0.90	8.46	6.00	6.11	5.24	5.75
S&P/ASX 300 Accumulation Index	2.94	5.30	14.70	6.48	2.02	5.23
Active return^	-1.14	0.86	2.30	2.33	2.90	4.09

Past performance is not a reliable indicator of future performance.

Performance figures are calculated after fees have been deducted and assume distributions have been reinvested. No allowance is made for tax when calculating these figures.

^ Numbers may not add due to rounding

Investment objective

The Fund aims to outperform its benchmark over rolling three-year periods.

Responsible entity

Fidante Partners Limited

Investment manager

Greencape Capital Pty Ltd

Investment strategy

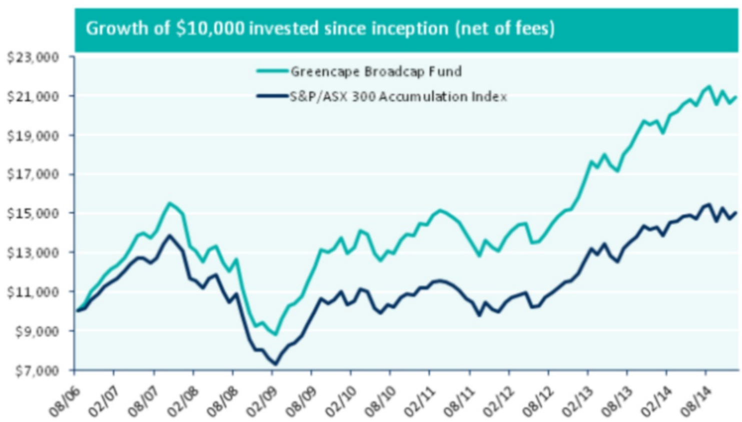
Greencape is an active, 'bottom-up' stock picker. Whilst Greencape does not target any specific investment style and will invest in stocks displaying 'value' and 'growth' characteristics, its focus on a company's qualitative attributes will generally lead to 'growth' oriented portfolios. This is an outcome of its bottom-up process. As such, Greencape's investment style may be classified as 'growth at a reasonable price'.

Distribution frequency

Quarterly

Suggested minimum investment timeframe

At least five years

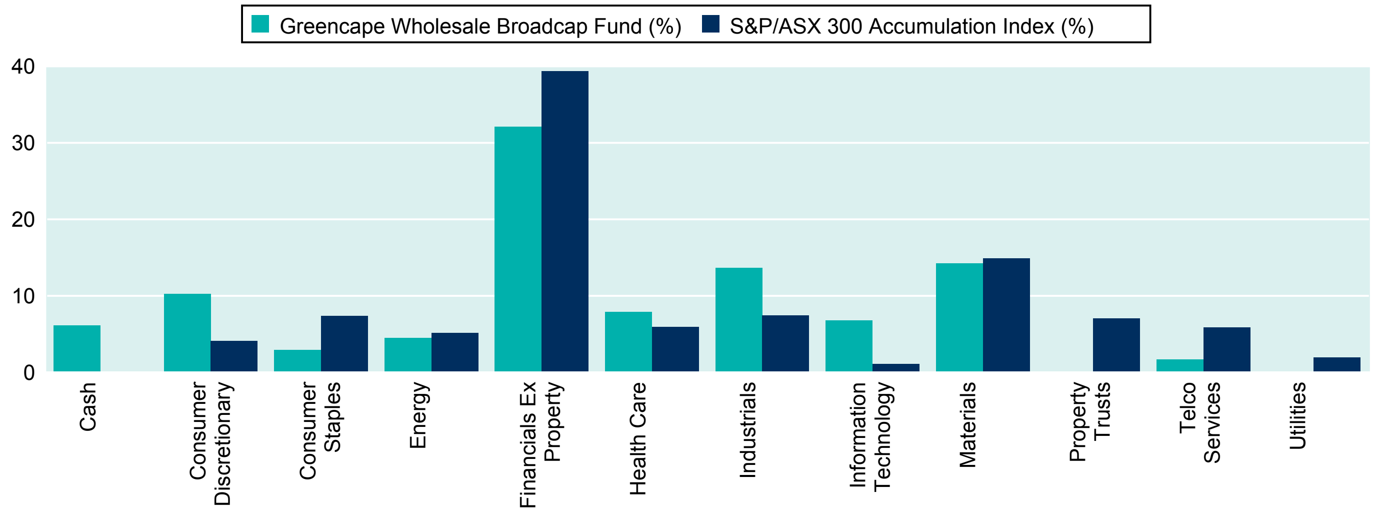


Asset allocation	As at 31 December 2014 (%)	Range (%)
Security	93.90	85-100
Cash	6.10	0-15

Fund facts	
Inception date	11 September 2006
APIR code	HOW0034AU

Fees	
Entry fee	Nil
2013-2014 ICR	1.45%
Management fee	0.95% p.a.
Performance fee	15% of the Fund's daily return (after fees and expenses and after adding back any distributions paid) above the Fund's Performance Benchmark (the daily return of S&P/ASX 300 Accumulation Index).
Buy/sell spread	+0.20% / -0.20%

Sector exposure as at 31 December 2014



Fund performance summary

The S&P/ASX 300 Accumulation Index returned +2.94% for the quarter. The fund underperformed the market and delivered a +1.81% return over the quarter.

The S&P/ASX300 Accumulation Index rose 2.9% for the quarter. The Greencape Broadcap Fund underperformed the Index and rose 1.8% (after fees).

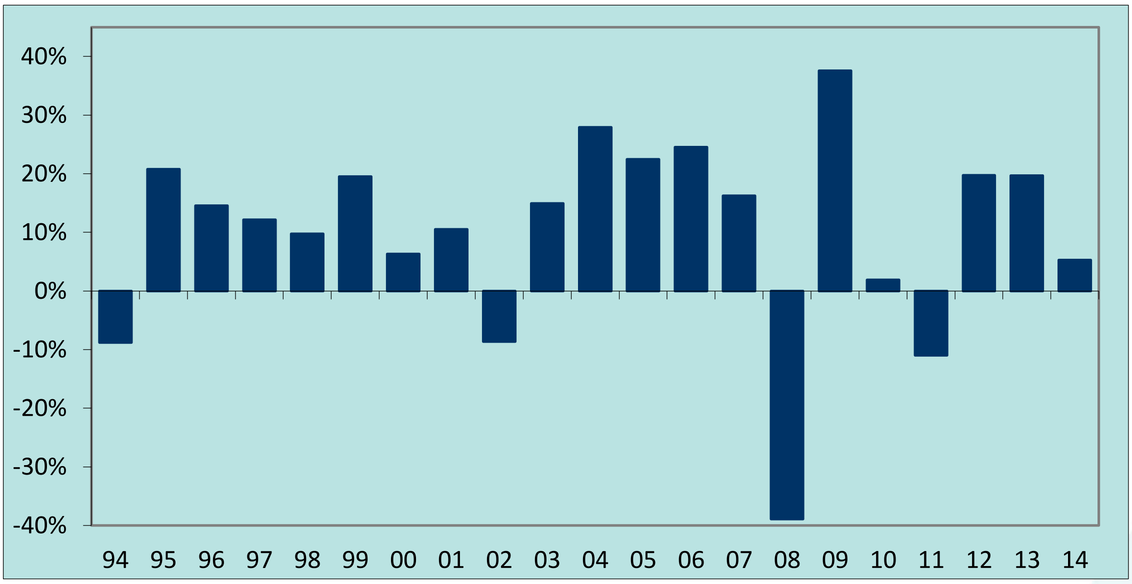
Market overview

The local Index started the month strongly in October, before commodity price weakness drove the market lower. After accounting for the reinvestment of dividends, the market finished the year slightly ahead but still well behind returns seen in the U.S. and China. The oil price seemingly fell off a cliff in November, wreaking havoc on energy stocks. The AUDUSD cross rate continued to fall, cratering 7% for the second consecutive quarter. Daily volatility continued to reign supreme in global markets as the VIX index closed up 18% for the quarter.

S&P/ASX 300 Accumulation Index

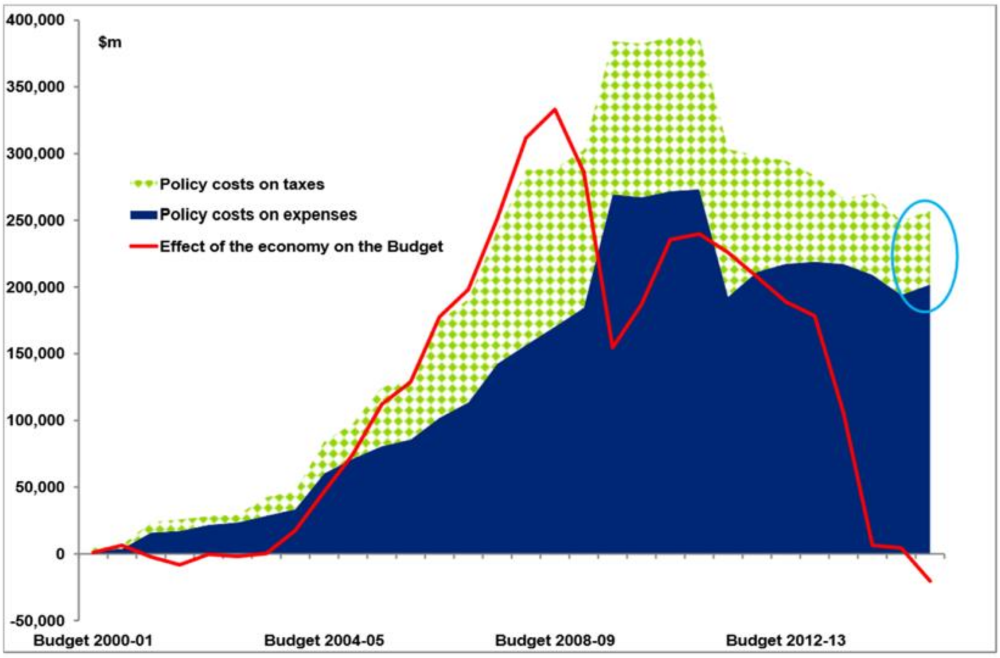
As expected the Reserve Bank of Australia (RBA) again chose to stay on the sidelines during the quarter, keeping the cash rate at the record low level of 2.5%. Rhetoric surrounding the cash rates changed markedly during the period from assumed rate increases in 2015 to expectations of a fall, with futures prices now implying a rate of 2.38% in March, falling to 2.17% by September 2015. Local data was mixed, with retail sales registering only 0.1% growth for August before rebounding to 1.2% growth for September. Building approvals fell 11% for September, considerably missing survey expectations of a 1% fall.

S&P/ASX 300 Accumulation Index Calendar Year Returns Since 1994



In the Mid-year Economic and Fiscal Outlook released in December, the budget deficit ballooned out to $40.4bn due to a collapse in commodity prices. The government has assumed iron ore prices of USD$60 for the next two years. The chart below shows the dichotomy between fiscal policy and the effect of the economy on budget revenues.

The impact of the economy and policy decisions on the Budget



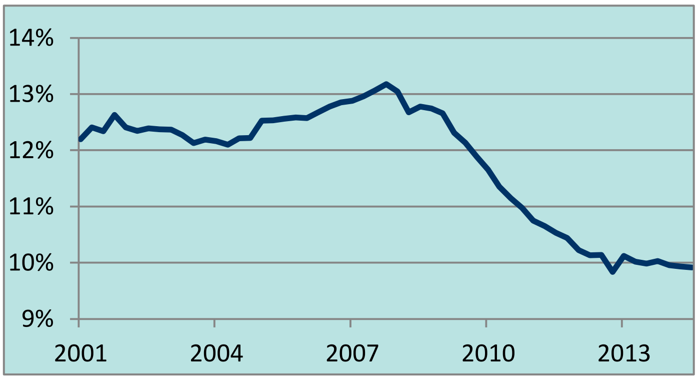
Source: Business Insider

"The real issue is that five-year-plus horizon where as a community we have voted for good things to be given to us by the government, or done for us, and we have not voted for the revenue that pays for it. " Glenn Steven, Governor of the RBA, 12/12/2014

Greece re-emerged as an issue during December, with the country heading for an early election after the Prime Minister failed to get sufficient backing for his proposed candidate. Syriza (the anti-austerity party) is currently favoured to win the upcoming election on 25 January 2015. The local stock exchange in Greece fell 22% for the quarter, while the Euro fell 4%. Comments from German Chancellor Angela Merkel that a Greek exit from the Euro would be 'manageable' also spooked global markets. Greece's GDP has shrunk 25% since 2008.

U.S. markets fared well during the period, with the S&P500 closing up 4.4% and 11.4% for the quarter and 2014 calendar year respectively. Data from the U.S. continued to be strong, with Q3 GDP revised up to 3.9% growth. Gains in the past two quarters represent the best six-month stretch of growth since late 2003. US non-farm payrolls registered a net addition of 321,000 in November, which strongly beat expectations of a 230,000 rise. This was the 10th successive month of net additions over 200,000. In December, the U.S. Consumer Confidence Index reached its highest level since February 2008. The Federal Reserve also completely wound down its QE3 bond buying program during the quarter.

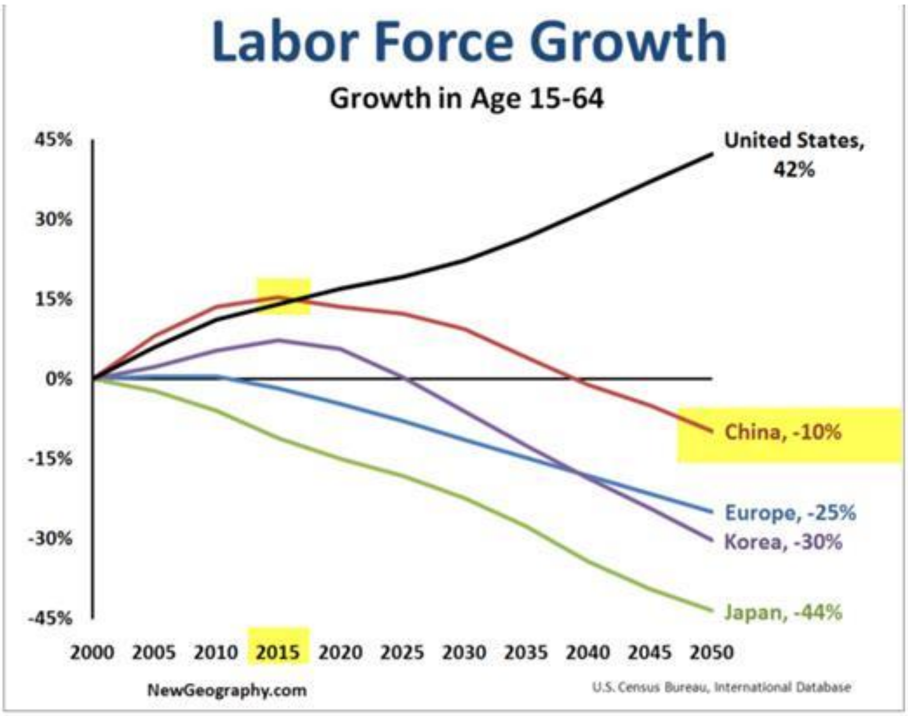
Household Debt Service



Source: Bloomberg

The above chart shows debt payments as a percentage of disposable income. This is ratio is now at a record low level since it started being published (in 1984), which represents a tailwind for U.S. consumers.

The Shanghai Composite Index was the best performing major exchange, posting a 52% gain for the calendar year. Chinese GDP grew at an annualised rate of 7.3% in the Q3, marginally beating expectations of 7.2% growth. Japan (technically) slipped into a recession, as GDP growth was negative for the two consecutive quarters. This prompted Prime Minster Shinzo Abe to call a snap election in December, which he subsequently won. The Bank of Japan also announced a fresh round of stimulus, expanding its asset purchasing plan by 20 trillion Yen, to 80 trillion Yen per annum.



Source: CLSA

The changing demographics in the Chinese population is predicted to hit a peak in the near future, reducing the labour force growth rate.

Locally, November brought AGM season which saw many companies update their earnings guidance. Positive trading updates included those from JB Hi-Fi, Qantas and Sims Metal, while negative updates included those from Nine Entertainment, Flight Centre and Sonic Healthcare. Medibank Private also listed, with the float representing the second biggest IPO in Australian history behind Telstra. The main story however was the collapse in the oil price and ensuing effect on companies with energy exposure.

	Dec 2014 Quarter	Year ended Dec 2014
ASX300 Accumulation Index	2.9%	5.3%
Best performing sectors		
Healthcare	13.3%	23.0%
Telecommunications	12.3%	20.6%
Property Trusts	11.3%	26.8%
Worst performing sectors		
Energy	-17.7%	-12.3%
Materials	-6.1%	-11.9%
Consumer Staples	-4.4%	-4.3%

Interestingly, the top 3 performing sectors were identical for Q3 and Q4 in 2014. Healthcare was again the best performing sector, as the sector's USD tilt helped it outperform the market strongly. CSL (which comprises half the Healthcare Index) announced the acquisition of Novatis' global influenza vaccine business for USD$275m. Management set expectations for the business for $1bn of sales over the next 3-5 years and a target EBIT margin of 20%. Resmed also reported a strong 1Q15 result which highlighted stable prices, strong volume growth and improving market share.

Telecommunications also fared well, as the market favoured bond-like equities as bond yields fell globally. During the period, Telstra completed a $1bn off-market share buyback and also announced the acquisition of Pacnet for $697. Pacnet is Asia's biggest operator of subsea cables.

Property Trusts also performed well as the investor thirst for yield was renewed with vigour. Westfield Corporation outperformed as companies with USD earnings were bid up as the AUDUSD cross rate fell.

Energy was the worst performing sector by a considerable margin as WTI Crude oil fell 42% during the quarter. Santos was forced to abandon its European hybrid issue given the oil price move, which saw its credit rating downgraded. The company then came out and announced it would be reducing 2015 capital spend by 25%, while also reiterating its position of not needing to raise fresh equity. WorleyParsons, which is a service provider to the energy sector, was also sold off heavily during the period. The company hosted an investor day where management spoke about repositioning business for an ongoing downturn. We discuss the oil price fall in more detail later in the quarterly report.

Materials again underperformed as iron ore spot prices fell another 9% during the period from already depressed levels. Spot prices fell 47% for the year. Small and mid-tier iron ore producers with higher operating costs were heavily sold off as the spot price rebound they were hoping for never eventuated. Mount Gibson Iron was severely sold off after the main pit seawall collapsed at its Koolan Island mine. BHP Billiton also fell, given the company's large exposure to oil. James Hardie outperformed after the company posted a better than expected Q2 result, which was aided by a strong trading result from the company's Asia Pacific fibre cement division.

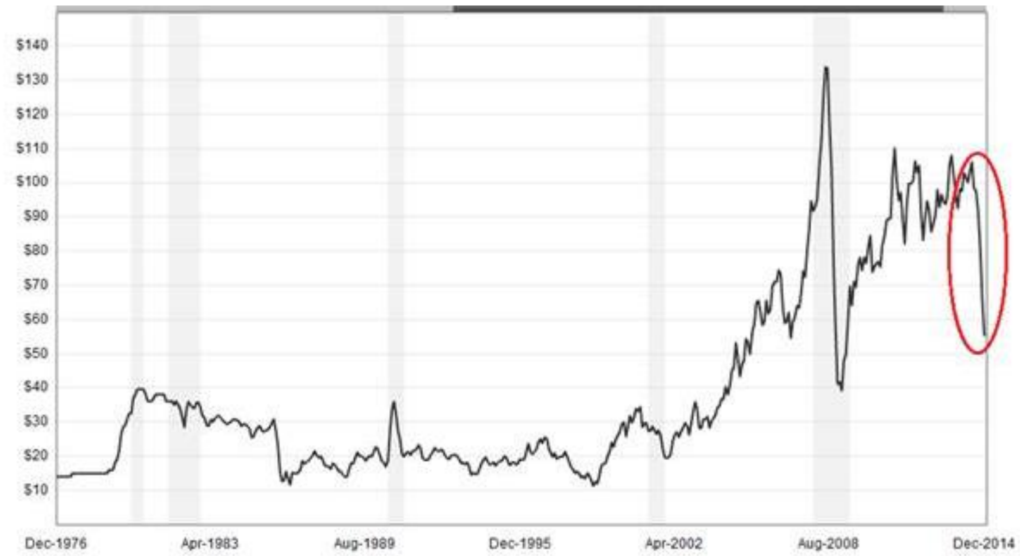
Consumer Staples underperformed as Woolworths released its 1Q15 trading update, which reported below expectation like-for-like sales growth for Australian Food & Liquor of 2.1%, due to softer trading conditions in August and September. The dominance of the incumbent major supermarkets was questioned by investors during the quarter, and we discuss this later in the quarterly report.

"… even though CET1 requirements were not breached, it is unlikely that Australia would have the fully-functioning banking system it would like in such an environment." Wayne Byres, Chairman of APRA, 10/11/2014

Oil

The main talking point in the market has been the sudden collapse in the oil price over the past few months. While some market commentators were bearish on oil, no one predicted the magnitude and velocity of the fall in the futures contracts for Brent and WTI Crude. During the most volatile days, it was not uncommon to see an 8% trading range in a single session of the January contract. This price action wreaked havoc on producers, with the S&P/ASX300 Energy Index falling 17.7% over the quarter. The price action was particularly savage for companies who had financial leverage on top of their operating leverage.

WTI Crude 1976 - Current

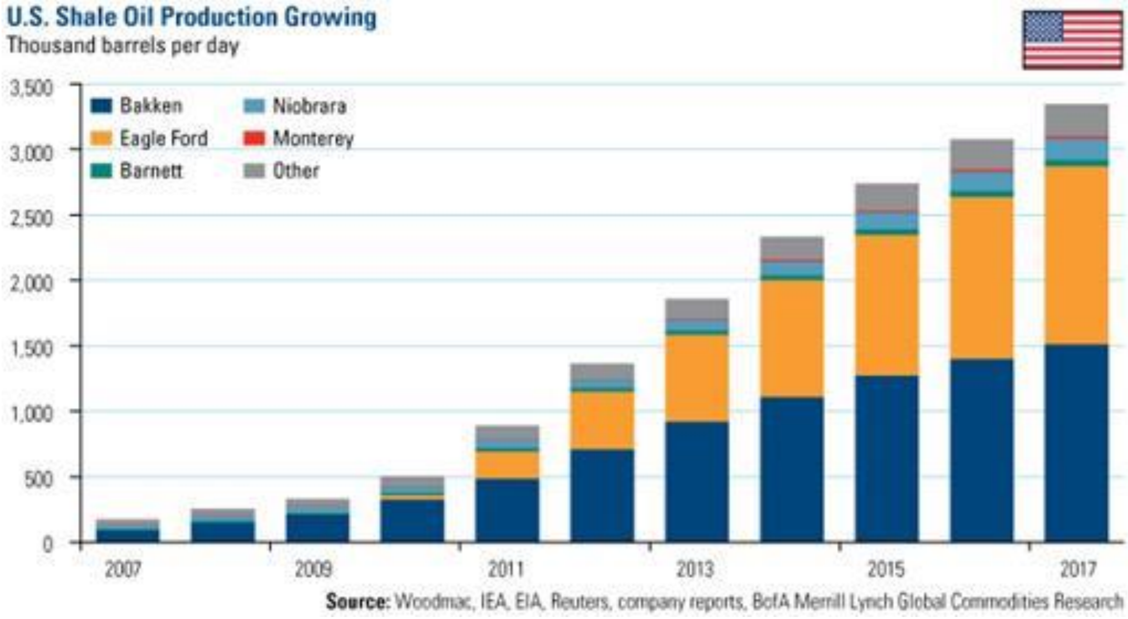


Source: Macrotrends

Due to the sudden drop in oil prices, the general consensus in market was that OPEC would cut production at their December meeting. The market's positioning was revealed after oil futures and stocks were sold off heavily after the announcement. However, if we study the history of OPEC decisions in the recent history of price falls in the oil price, they have historically not cut production in the first meeting following a sudden fall. For example, following the 9/11 attacks in 2001, spot prices fell 35% from September through to November. OPEC delayed cutting production until January 2002. In 2008, oil reached a record price of $145 in July. As a result of the financial crisis, the commodity fell over $50 to $91, after which time OPEC then cut production three times in three months. History suggests that OPEC has allowed its members (and other oil producing countries) to feel some degree of fiscal pain before stepping in to cut production and this time appears no different.

"If oil prices remain low, repatriation of foreign assets could generate capital outflows, and potential financial strains for countries that have become reliant on 'petro-dollar' inflows." World Bank report, January 2015

Unconventional oil production (in particularly shale oil) has increased markedly in the past 5 years and is expected to balloon further, especially in the U.S.



Source: Merrill Lynch

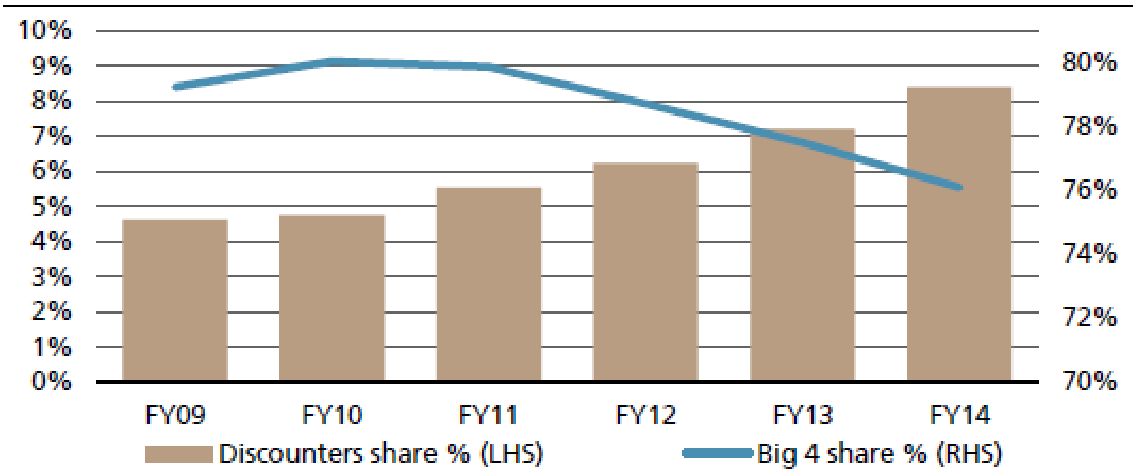
Conventional production is characterised by large initial capex, followed by minimal amounts of ongoing capex during production. Shale however, requires a large amount of ongoing capex given the rapid depletion of producing wells, therefore the economics of the projects are different. For shale projects, production becomes less economical a lot quicker as the oil price declines compared to conventional projects. This suggests there is some fat to be trimmed in the forecasted shale production growth which should result in a rebalancing of supply growth back in line with demand growth and hence a stabilisation (and eventual increase) in oil prices. Contrast this with the iron ore market in which the low-cost major miners continue to grow supply at a greater pace than demand growth despite a falling iron ore price which has declined by a similar magnitude as the oil price over 2014. A rebalancing of this market is likely to be longer dated than the oil market.

Supermarkets

During the quarter, Australian supermarkets, in particular Woolworths came under pressure. The bearish argument is more structural than cyclical, with the belief that supermarkets are currently overearning, with their EBIT margins (which are the highest globally) to come under pressure as the discount chains gain traction.

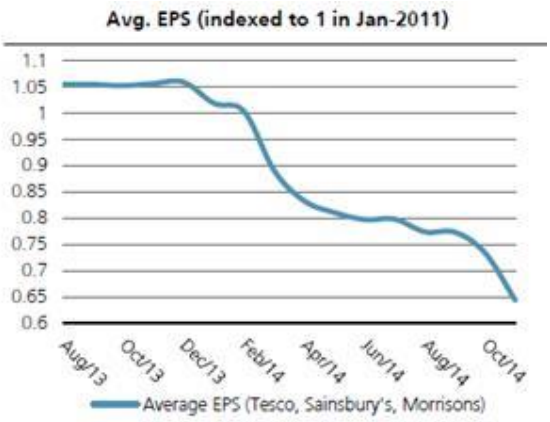
UBS released a detailed report on the subject, which highlighted there was precedent for discounters acting as a disruptor to the market and driving down earnings margins for incumbent supermarkets.

While by no means a perfect comparison (higher population density, more competitive markets, very large store formats, increased convenience offers), the UK provides an insight into the impact of discount chains when major supermarkets allow EBIT margins to rise. Since 2009, the Discounter share of grocery sales has more than doubled, taking share away from the four incumbent chains.



Source: UBS

The reaction from the major supermarkets was to cut prices to regain customer traffic however it takes time to shift consumer behaviour which had grown accustom to the value (both perceived and actual) on offer at the likes of Lidl and Aldi. The effect on the share prices and earnings of the 3 listed supermarkets has been profound in the past year, falling more than 30% and EBIT margins in some cases halving.

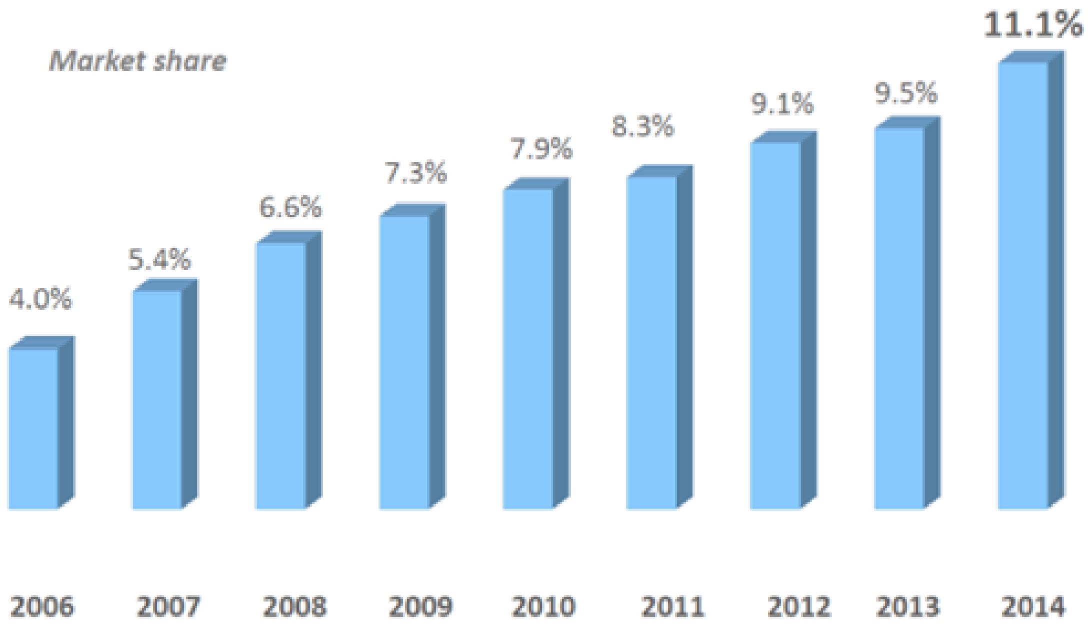


Source: UBS

In Australia, ALDI and Costco are the discount chains currently expanding their presence. ALDI is the more aggressive of the two given its smaller format stores, and ability to be located both inside and outside shopping centres. During a recent research trip to Perth, we noticed the prevalence of ALDI seeking multiple sites in the local market. All the property developers we spoke to were in contact with them, as ALDI were actively seeking stores at brand new and existing brown field sites across Perth. This is a region that has historically been dominated by Woolworths and Coles. Similarly, South Australia is also a growth market for Aldi, with the incumbents being the Metcash supplied independents who have traditionally done a great job at servicing the market. We understand through various industry contacts that Aldi have a number of sites earmarked and their South Australian expansion is likely to commence in 2015.

"We have some very difficult changes to make... we are facing the reality of the situation." Dave Lewis, CEO of Tesco, 08/01/2015

Recent Neilsen data suggests that ALDI's market share has already climbed to 11% in 2014, and we note that this only takes into account the eastern seaboard. This growth has been faster than the UK, given ALDI has been the only discounter to roll out a large number of stores, whereas in the UK they have competed with Lidl (who do not yet have a presence in Australia).



Source: Nielsen, MAT July 2014

If we consider Aldi's footprint across both the existing eastern seaboard (apparently targeting 500-600 stores, current base of around 350), and its potential across South Australia and Western Australia (perhaps another 100 combined), this would provide them with around 10% less than the current Coles footprint of approximately 750 stores. Given Aldi's significantly reduced SKU count compared to the major chains which have better breadth of product, the volumes across individual line items at Aldi would in some instances be larger than Coles and Woolworths. Volume in the supermarket industry is important, as it provides the ability to fractionalise fixed costs and gain better buying terms from suppliers. With Aldi potentially having more favourable supplier terms than the majors in key line items, this is likely to ensure pricing and EBIT margins of the major chains remains in check.

Source: Morgan Stanley

This photo was taken on the opening day of Aldi in Dubbo. People lining up for groceries shows a lack of consumer loyalty to Coles and Woolworths.

Already, we have noticed a subtle shift in positioning with Coles, who are re-emphasizing and extending its "Down Down" marketing campaign with "Down Down Everyday". Their strategy of reducing prices in key value items is an attempt to drive momentum in the business by winning additional market share and volume. Woolworths have responded with its "Cheap Cheap" campaign, however as seen in their recent sales results, momentum has slowed with promotional initiatives failing to resonated with customers as well as Management would have hoped.

Given the industry dynamics, we do not expect industry EBIT margins to expand as they have done over the last decade. The operational improvements within the Coles supply chain, further store refurbishments, and a lower starting point with respect to its own EBIT margins suggests Coles has more flexibility compared to Woolworths. We also note that the recent margin benefits gained by both major chains from pressing suppliers will be more difficult going forward given the spotlight by the ACCC on supplier negotiations. We are overall cautious on the Australian supermarkets in light of the above. Whilst we do not anticipate a UK type scenario (halving of EBIT margins), we do believe that sales momentum will remain under pressure and ROIC will drift lower going forward which will likely weigh on share prices.

We undertook some research trips focused on offshore retailers during the quarter, and we discuss our findings below.

Overseas Trips

During the quarter we undertook research trips to the US twice, New Zealand twice, Europe, Hong Kong and Singapore.

US Broadcasting/Technology

- **Content**; Increasing demand and competition for original content due to additional viewing windows means owning and/or control of rights is where the value resides. Previously it was only Netflix, now Hulu is reinvigorated, and Yahoo are increasingly moving into original content whilst broadcast and cable channels continue to also chase key hit shows in order to build and grow their respective channels. This is set to continue.
- **Viewership**; Total time spent watching programs appears to be rising (if you take c30, i.e. 30 days after first airing), however the younger audience is being fragmented away from traditional sources hence the ability target the younger demographic via other means is an increasing priority. Strategic bets are being made now with Multi Channel Networks within YouTube the focus.
- **Retransmission consent/reverse re-trans**; Continues to be a strong earnings story for network TV owners, with the current pace of growth likely to continue in the medium term which helps mitigate potential near term advertising cycle risks.
- **Advertising markets**; Expect significant change in the next 12-24 months with better measurement, increased programmatic buying, and more active dynamic ad insertion likely to see wholesale changes to the way advertising agencies, and distributors operate. Those who own the content/distribution rights are likely to see increases in monetisation due to better alignment/accuracy.
- **Film**; There are fewer titles being made but studios are betting up with key (generally super hero/book type) franchises in order to de-risk, leverage international audiences, and differentiate the cinematic experience vs the smaller screens.
- **International**; Growth remains very strong as rights are being bid up, not just by Netflix but also by local Over-the-Top operators. Content owners are wary of not aligning rights to any one provider in order to ensure tension remains in the market. Also, emerging markets are in general consuming more content with India named a number of times as a strong growth market going forward.
- **Internet**; Scale names are taking a 10-15 year view of the market, and are now large enough to play a significant role in shaping their respective segments. They have material amounts of data to leverage going forward and have only just started to address this. Whilst there's always risk of new technology disrupting the current status quo, this is becoming increasingly difficult as the incumbents are now in a unique position where their organic cash generation means potential threats are acquired and integrated into their ecosystem before they pose a material risk to the user base.
- **Cloud**; There is a big trend towards Cloud and SaaS (Software as a Service). These services are generally subscription based pricing with operating leverage in year 2 onwards after making the sale. The software vendors are pushing it, with Microsoft's Cloud revenue up 147%, but still equates for only 9% of license sales. Microsoft said in their presentation that "its still early in the cloud transition".
- **Gaming**; Bally and Aristocrat are leading the industry on product innovation with major competitors commonly distracted with mergers. There are however new small players popping up each year, collectively growing market share.

"The key challenge for us is to build these (digital platform) choices in ways that fairly compensate us for our content and brands, and do not undermine more established business models." Chase Carey, COO of Twenty-First Century Fox, 07/11/2014

"It's (oil price decline) something that is certainly good for families, for households. It's putting more money in their pockets, having to spend less on gas and energy, and so in that sense it's like a tax cut that boosts their spending power." Janet Yellen, Chairwoman of Federal Reserve, 17/12/2014

Supermarket Trips

Over the past quarter, we have now done 'deep dives' into the North America, UK and French grocery channels and associated supply chains with a view to assessing the threat to Australian incumbents, Woolworths and Coles from the emergence of Aldi and Costco as viable competitors.

What is clear is that whilst those incumbents such as Krogers in the US (and French supermarkets generally but notably Carrefour) that moved quickly to adjust pricing to protect their position from new entrants (i.e. discounters) wore considerable (and more immediate) pain, they did markedly better than their counterparts, such as Safeway in the US who staunchly stood their ground until they lost quantum market share and volume at which point they had little option but to 'reinvest' in price. Tesco and Morrisons were the slower to move in the UK, again at considerable cost.

As discussed earlier in the quarterly report, we see some parallels between Woolworths in Australia and the UK supermarkets, whereas Coles appears to have been much more proactive and accepting of the market shift (as per Krogers).

Like other markets we have visited, discounters in Australia have become an accepted format and whilst Aldi currently has over 10% share, evidence from offshore suggests this is likely to increase further. There is a clear power-shift away from the incumbents in Australia, with the performance of Metcash evidence of this. Whilst the Independents (IGA's and others) have so far provided an effective market share cushion to Woolworths and Coles, this may become harder going forward. We expect both Woolworths and Coles to ultimately cede share (and or margin).

It is important to remember that in Costco and Aldi, you are competing with the 3rd and 9th biggest retailers globally – a very different proposition to dealing with (sometimes) underfunded independents.

Outlook

Greencape observe that deflationary pressure (and concerns) has increased due to continued U.S. dollar strength and the sharp fall in the oil price. This is resulting in lower for longer interest rate expectations globally. The U.S. 10 year yield has just dropped below 2% with the Australian 10 year yield now at record lows. The resultant equity market impact is another round of rotation towards yield stocks and defensive 'growth at reasonable yield' stocks.

We observe continued flat economic activity in Europe and slowing growth in China despite stimulus attempts. Whilst in the U.S. we see improving growth with mixed but generally positive economic data. Here in Australia we are observing patchy economic activity with a weakening mining sector, low consumer confidence but improving discretionary spending power, courtesy of the oil price fall.

Unfortunately a cycle uplift to drive equity earnings is not observed, so self-help growth drivers remains key. Many companies' internal cost out programs are approaching an end point, so self-help for some stocks depends increasingly on M&A activity. The value of shareholder stewardship from management and boards only increases in our view, as does a company's optionality in terms of M&A opportunities, positioning and importantly, balance sheet.

Despite the material macro driven rotations, the large resultant share price moves rewards stock picking. Greencape strives to consistently execute its process during these turbulent times.

"Should it become necessary to further address risks of too prolonged a period of low inflation, the Governing Council is unanimous in its commitment to using additional unconventional instruments within its mandate… (which) may entail the purchase of a variety of assets one of which could be sovereign bonds." Mario Draghi, President of the European Central Bank, 08/01/2015

"There are a few other reasons to suspect that the sell-off, particularly in fixed income, could be relatively violent when it comes…When funding costs are no longer zero, those positions will blow up." Guy Debelle, RBA Assistant Governor (Financial Markets), 14/10/2014

More information

To find out more about investing with Greencape, please contact:

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