Greencape Wholesale Broadcap Fund

Quarterly report - September 2016

Performance #	Quarter %	1 year %	3 years % p.a.	5 years % p.a.	10 years % p.a.	Inception % p.a.
Fund return	4.51	14.72	7.31	12.88	8.52	8.90
Growth return	3.45	8.69	-0.49	6.10	2.35	2.74
Distribution return	1.07	6.03	7.80	6.78	6.17	6.16
S&P/ASX 300 Accumulation Index	5.24	13.50	6.03	11.02	4.99	5.25
Active return^	-0.73	1.22	1.28	1.87	3.53	3.66

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

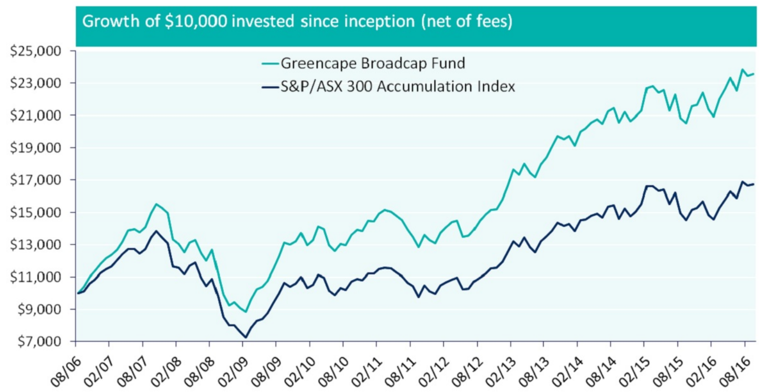
Greencape is an active, 'bottom-up' stock picker. Whilst Greencape does not target any specific investment style and will invest in stocks displaying 'value' and 'growth' characteristics, its focus on a company's qualitative attributes will generally lead to 'growth' oriented portfolios. This is an outcome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

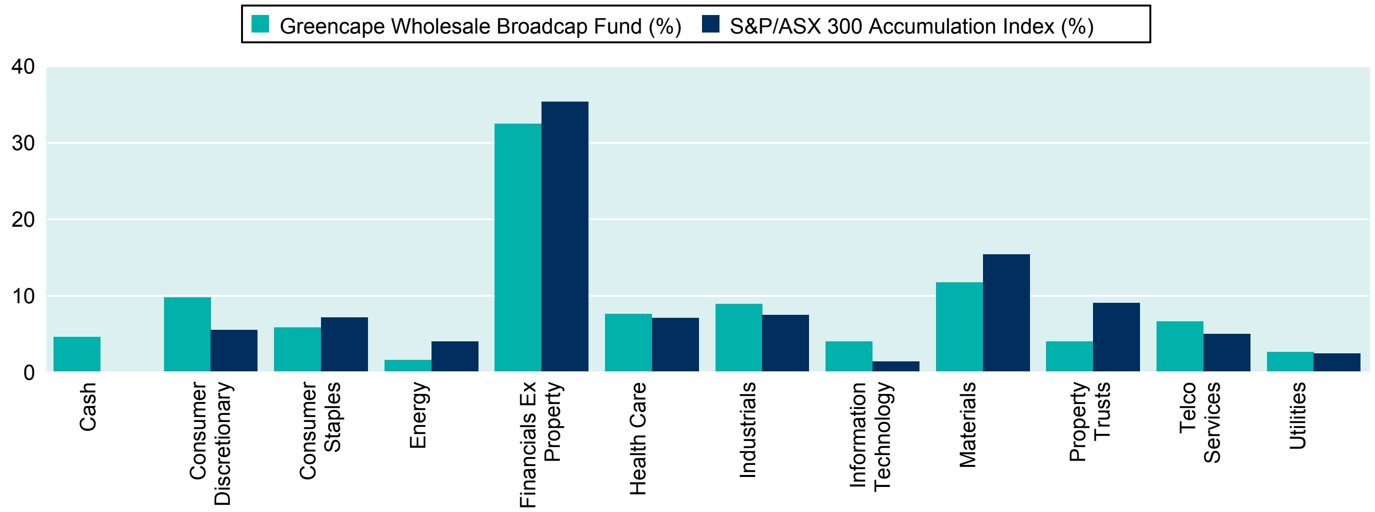


Asset allocation	As at 30 September 2016 (%)	Range (%)
Security	95.40	85-100
Cash	4.60	0-15

Fund facts	
Inception date	11 September 2006
APIR code	HOW0034AU

Fees	
Entry fee	Nil
2015-2016 ICR	1.37%
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 30 September 2016



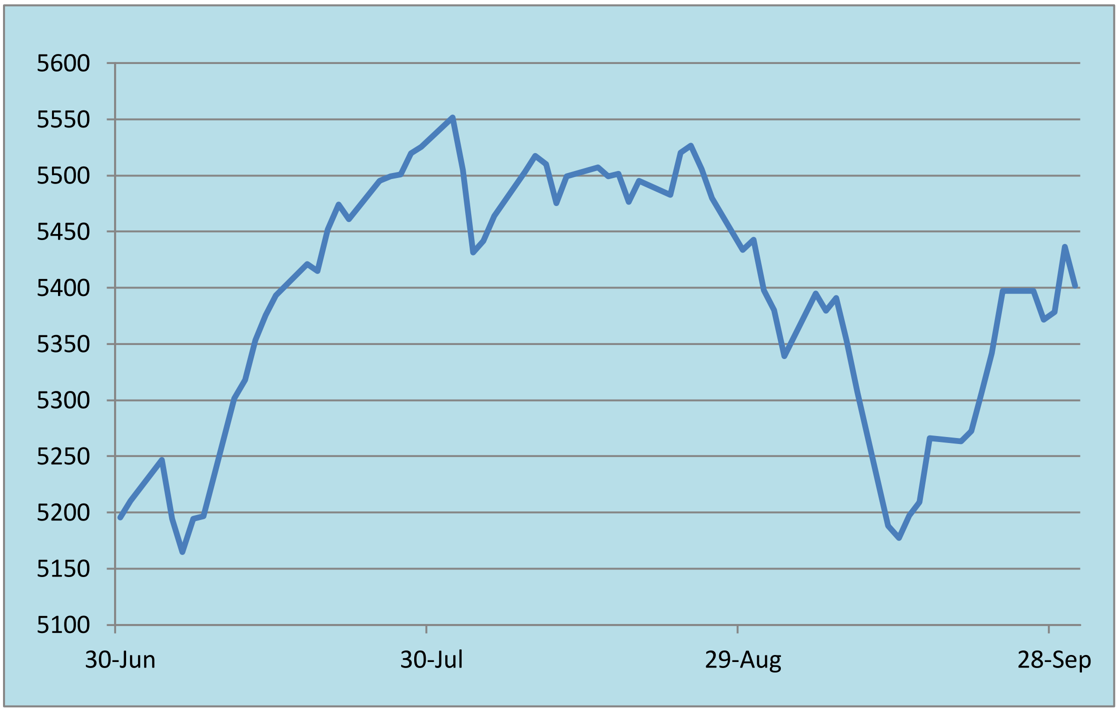
Fund performance summary

The S&P/ASX 300 Accumulation Index returned +5.24% for the quarter. The fund underperformed the market and delivered a +4.51% return over the quarter.

Market overview

The market endured a shaky start to the period in the wake of the Brexit result, which locally was compounded by the result (or lack thereof) in the Federal election. The expectation of incremental central bank stimulus coupled with further flattening of the yield curve saw markets stage a remarkable recovery in July. In August the local market's focus shifted to the reporting season, which brought with it mixed results. Global banking jitters spooked markets late in the period, however indexes again found a way to quickly recover from the sell-off.

S&P/ASX 300 Index

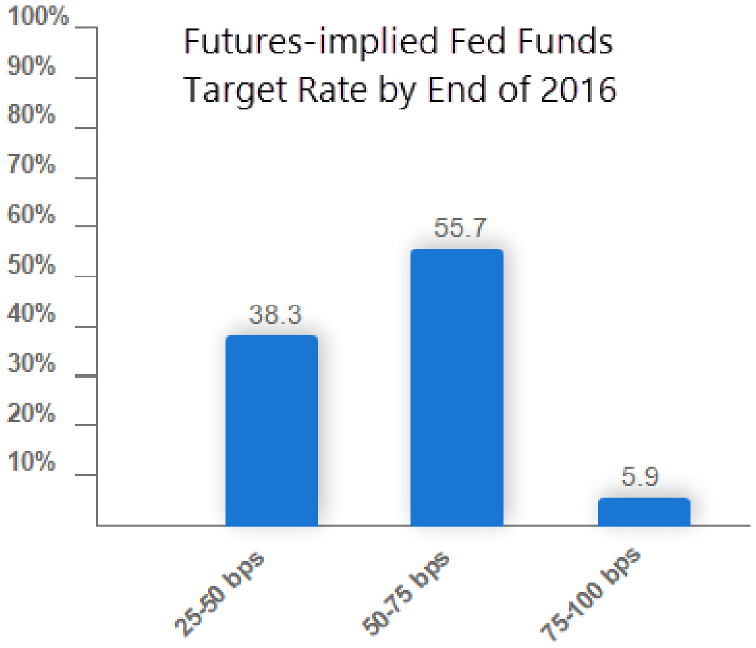


"It's their decision and they have to explain their decision to their customers and I'm saying there is no cost of funds issue offshore that would prevent them from passing on that full rate." Scott Morrison, Treasurer of Australia, 02/08/2016

In August the Reserve Bank of Australia (RBA) cut the overnight cash rate for the second time this year to a new record low of 1.5%. There was some controversy however, as major banks chose to pass on less than half the 25 basis point cut, while simultaneously increasing deposit rates. The Federal government's decision to call a double dissolution election initially appeared to have backfired as the result seemed headed towards a hung parliament, similar to what occurred in 2010. However more than a week after the poll was held, it was announced that the Coalition would be able to form a one-seat majority government in the House of Representatives. The Coalition didn't fare as well in the Senate however, winning 30 of the required 39 seats to form a majority. A record 20 Senate seats were won by crossbenchers, with Pauline Hanson's One Nation Party securing 4 seats, as the far-right wing party polled over 9% of the primary vote in Queensland. Whilst the election outcome was still to be determined, S&P placed Australia on a credit watch 'negative' outlook.

As has become the norm, markets continued to gyrate around expectations of central bank moves. As expected, the US Federal Reserve (Fed) kept rates on hold in September despite some Fed members hinting that the meeting was 'in-play' for a rate rise. Economic data out of the US was generally strong, with the non-farm payrolls for July registering a gain of 287k, versus market expectations of 180k and the previous gain of only 11k.

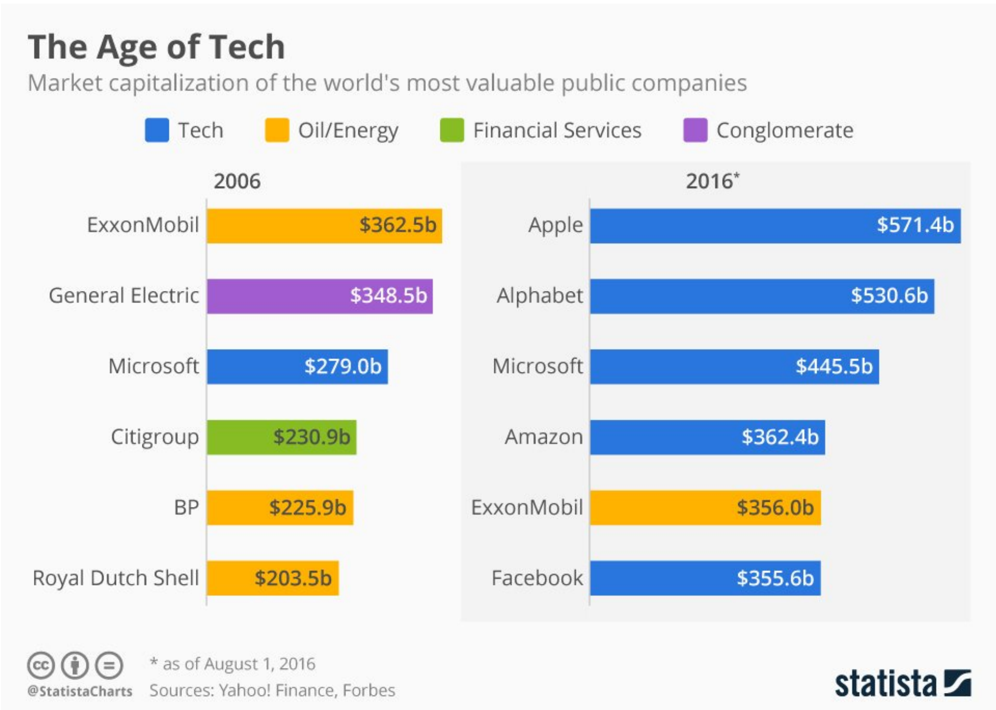
Markets now attribute a greater than 60% probability of a rate hike in the US by year's end, with the most likely outcome being a 25 basis point rise in December, as the November meeting falls a week before the Presidential election.



Source: CME

The Bank of England and Bank of Japan (BOJ) both announced new stimulus packages centred on large scale asset purchases. The BOJ however went a step further, announcing it would aim to keep the 10 year government bond rate around 0% in order to boost inflation to its targeted 2% level. In China, Q2 Gross Domestic Product growth came in 0.1% ahead at 6.7% year on year, with June Retail Sales growing at 10.6% versus market consensus of 10% growth year on year.

The composition of the mega-cap end of the global stock market has changed markedly over the past decade as tech companies become more prevalent.



Source: Statista

"If you're not on AWS (Amazon Web Services) you're dead... You just may not know it yet". Rod Drury, Xero CEO, 09/09/16.

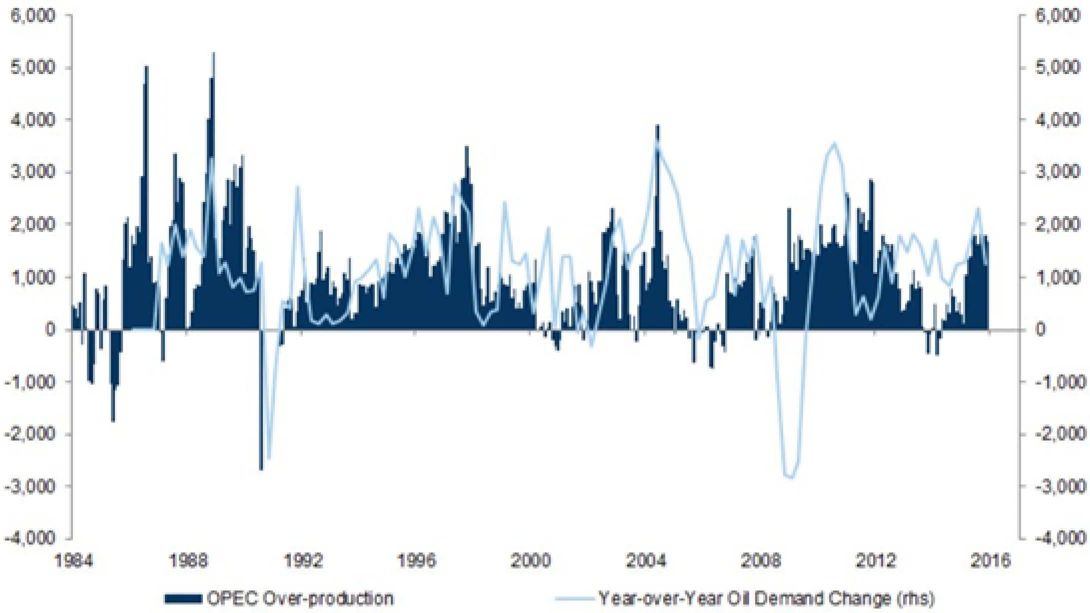
The local market became preoccupied with reporting season in August, which we discuss in more detail later. Commodity prices continued to rally, which resulted in Materials being the best performing sector in the market for the second consecutive quarter.

	Sep 2016 Quarter	Year ended Sep 2016
ASX300 Accumulation Index	5.2%	13.5%
Best performing sectors		
Materials	13.9%	24.3%
Consumer Staples	12.4%	12.2%
Information Technology	10.2%	15.9%
Worst performing sectors		
Telecommunications	-6.4%	-2.0%
Utilities	-2.3%	19.4%
Property Trusts	-1.9%	20.9%

Oil stocks finished the period strongly, as the Organisation of the Petroleum Exporting Countries (OPEC) announced it would agree to cut production by 750k barrels per day to 32.5m when they meet in Vienna in November. OPEC members currently produce around 40% of global oil, and this announcement is the first production cut by the cartel in 8 years.

Although OPEC members agreed to production quotas, over-production has historically been a regular occurrence.

OPEC production of countries under quota vs. their production target (lhs); Year-over-year change in global oil demand (rhs). In thousand barrels per day



Source: Goldman Sachs

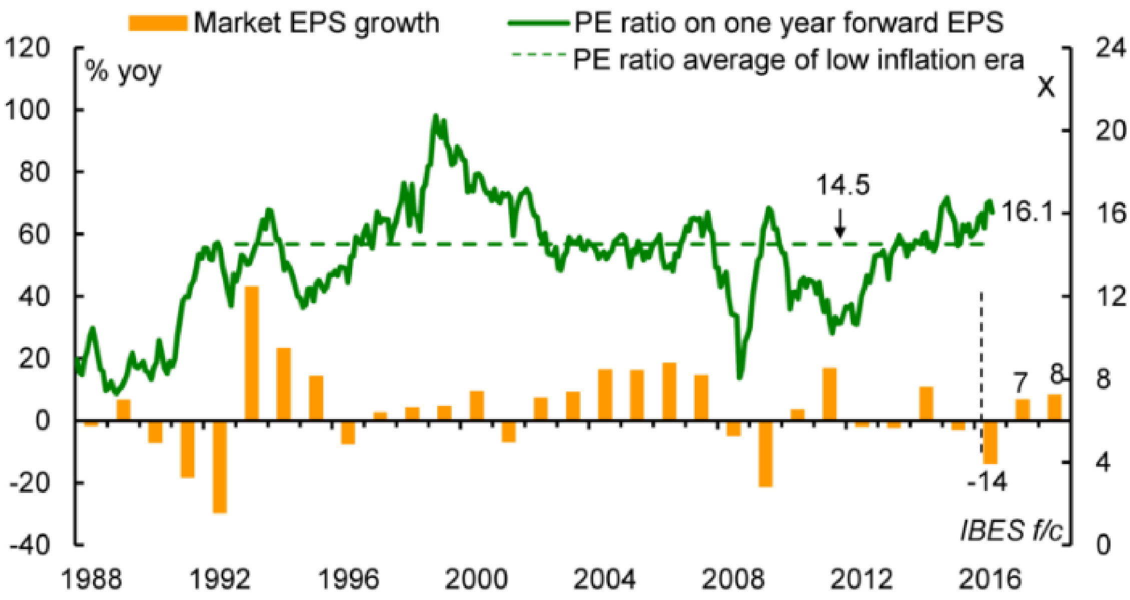
After rallying in July, interest rate sensitive stocks were sold off harshly in August, as market expectations that interest rates have bottomed saw global rotation out of bond-like equities into actual bonds. Whilst Telecommunication stocks also suffered somewhat because of changes to the rates outlook, there were also a number of 'bottom-up' factors which impacted their performance. TPG Telecom lowered its Underlying Earnings Before Interest, Tax, Depreciation and Amortisation (EBITDA) guidance for FY17, in part due to uncertainty in NBN access charges. The market saw this as also a negative for Vocus Communications, who also announced the resignation of their CFO, along with the sell down of the majority of the founder's stake.

"We have no incentive to lend people money for a home they cannot afford." Brian Hartzer, CEO of Westpac, 06/10/2016

Reporting Season

Reporting season brought with it a varying array of results, the quality of which were framed around the market's expectations leading in. Over the course of the reporting season, earnings expectations were downgraded around 2% for FY17. As we see below given share prices didn't commensurately de-rate, the Price to Earnings (PE) of the market remains elevated versus history.

Market EPS Growth and PE Ratio



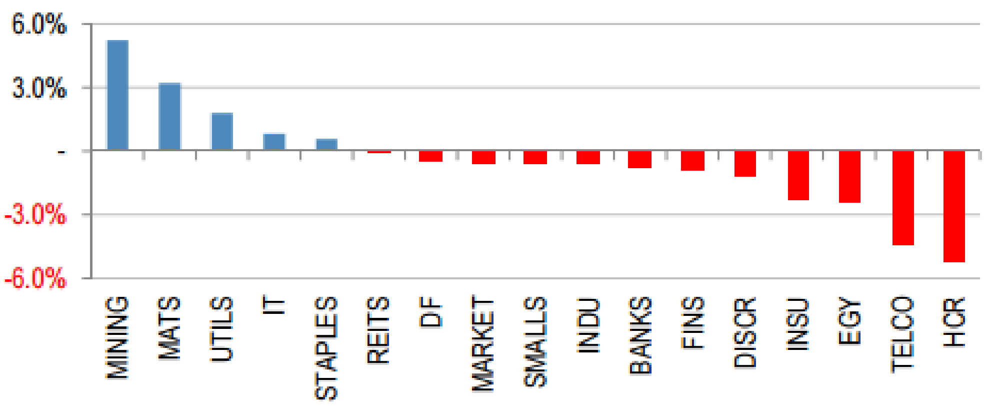
Source: Citi

The banks saw some pressure to Net Interest Margins, with only one of the major banks managing to post flat margins. Whilst Bad and Doubtful Debt charges were elevated compared to recent periods, they still remain low at an absolute level, with management commentary stating that they are mostly confined to the Resource sector.

The housing cycle showed no signs of abating, with retailers exposed to remodelling & renovating consumption such as Harvey Norman, JB Hi-Fi and Nick Scali all benefitting. In its results release, Harvey Norman cited positive customer responses to interest rate reductions and population growth driving new dwelling constructions and refurbishing of existing homes, particularly in NSW and Victoria as key contributors to the strong sales growth.

Due to gains in the underlying commodities, earnings revisions for mining stocks were the highest during August. These positive revisions continued into September, with FY17 Earnings per share estimates for Fortescue Metals, South 32 and BHP being revised up 55%, 34%, and 32% respectively since the start of August.

Blended Forward Earnings Revision by Sector



Source: JP Morgan

"I visit competitors' blood collection centres, it's like undercover boss." Paul Perreault, CEO of CSL, 19/08/2016

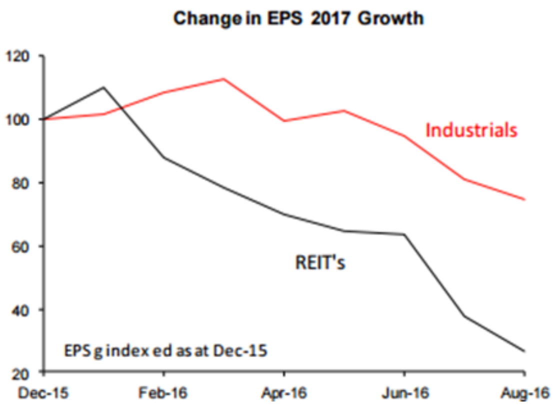
"In fact, house price growth has slowed over the course of the year, and I think that is good. As the father of three children, I do worry that people are paying so much for their housing. The solution to that… is housing supply and investment in transportation infrastructure." Philip Lowe, RBA Governor, 22/09/2016

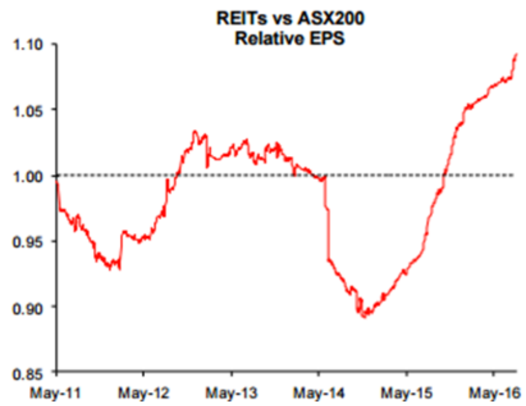
'Value' stocks such as Computershare, Ansell and Sims Metal with lower earnings multiples who reported in-line results tended to gain strongly, given low market expectations. Conversely, 'growth' stocks with higher multiples such as CSL, Medibank Private and Blackmores, were punished by the market for delivering in-line results with softer than expected guidance commentary.

Recently there has been significant market and media focus on default risk in apartment settlements in Australia, however in reality these risks appear to be benign to date as Mirvac and Lendlease both reported default rates of less than 1%. Whilst the reporting season is less relevant for Real Estate Investment Trusts (REIT's), we have noted that earnings growth has fallen away in recent times, whilst outperformance still remains elevated.

"You apologise when you do something wrong, I don't think we have done something wrong." Mauro Balzarini, CEO of Wellard Group, 31/08/2016

REITs EPS Growth & Outperformance

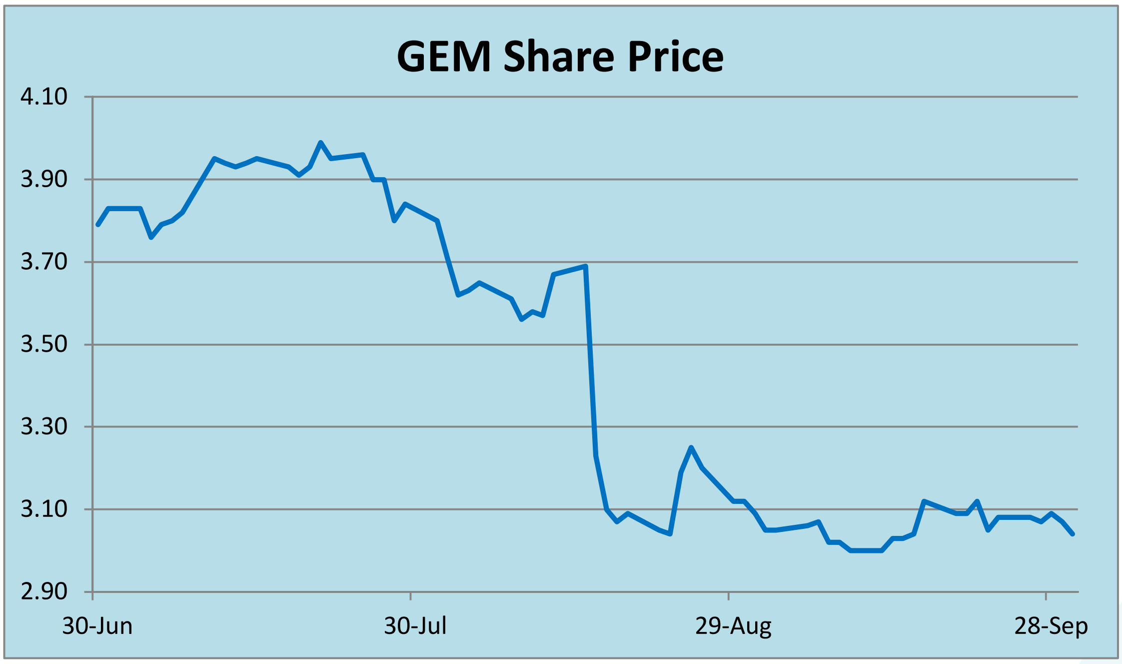




Source: Macquarie

G8 Education

We recently increased our shareholding in G8 Education Ltd (GEM), a national childcare operator, following a weaker than expected half year financial result (31 December year-end) in August, which we feel the share price over-reacted to. Interestingly, the amount of the share register sold short increased from ~ 3% to ~ 6.5% post the result and share price correction to the ~ $3.10 level, implying that many are betting on further downgrades to come.



Source: Iress

The weaker result was largely driven by higher than expected cost growth and coincided with the changeover in Chief Financial Officer (Garry Carroll joined as CFO on 25 July) which we think contributed to the prior poor communication with the market on these issues. We took some comfort that the weaker result was not driven by weaker revenues given the concern about rising supply of new childcare centres. The company has also said that the cost growth seen in the first half will subside in the second half of the year.

The revisions to consensus EBIT forecasts post the August result are shown below.

	2016	2017
Prior to result	$169m	$194m
Now	$158m	$175m
Revision	-7%	-10%

Source: Bloomberg

The market's earning revisions were in part due to an extrapolation of the cost growth issue above, an expected continuation of weakness in WA and a reduction in the assumed future number of childcare centres that GEM will acquire. On the latter issue, GEM have re-based market expectations to a lower level of acquisitions versus what they have done historically, which we feel is prudent given the company has guided to a Net debt-to-EBITDA ratio of 2.1x at 31 December this year.

Recently we've heard a number of negative points raised publicly by brokers and hedge funds, some of which we have specifically addressed below.

1. The dividend is unsustainable and GEM need to raise equity - Since December 2014 GEM has been paying a quarterly dividend of 6 cents per share (cps), or 24 cps p.a. Given recent earnings downgrades, consensus now sits at an earnings per share (EPS) estimate of 24.9 cps in CY16 and 27.4 cps in CY17*, which represents a dividend payout ratio (POR) of 96% and 88% respectively. Whilst this is relatively high, we note that GEM's gross operating cash flow conversion of EBITDA is typically ~ 100% (though we acknowledge that capex is > depreciation in CY16) and that GEM currently has a Dividend Reinvestment Plan (DRP), meaning it's actual dividend POR is much lower than the percentages above, albeit this comes at the cost of future EPS dilution.

Given we expect GEM to demonstrate organic earnings growth going forward and the existence of the DRP, we expect GEM to be able to hold it's dividend constant at 24 cps whilst gradually growing into a more comfortable dividend POR that will enable them to reduce their gearing ratio and future EPS dilution over time. At GEM's closing price of $3.04 that makes the dividend yield 7.9% fully franked, or 11.3% pre-tax!

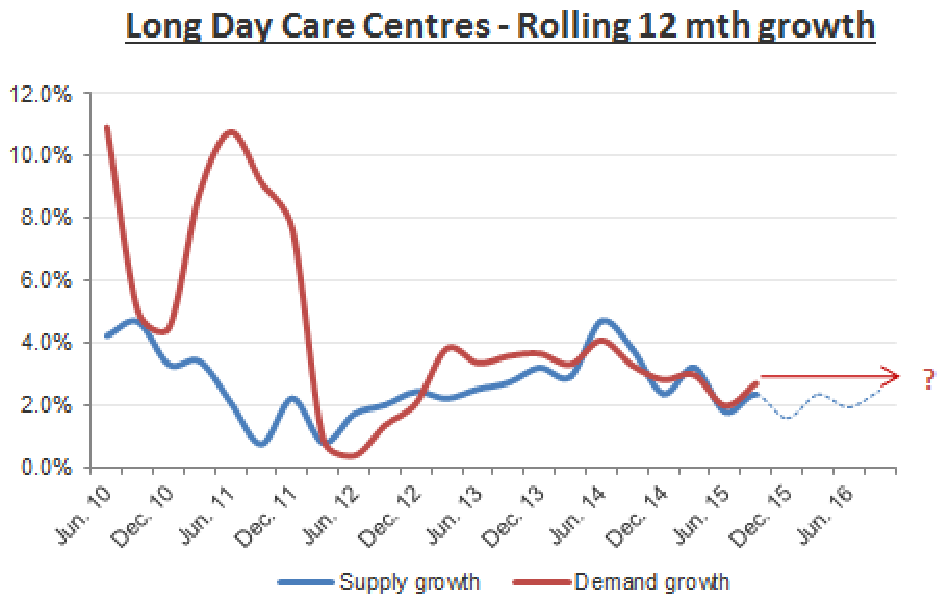
* Source: Bloomberg

2. GEM is no longer acquiring childcare centres on 4x EBIT - Forecasting GEM's earnings in the past was relatively straight forward. By looking at how much they spent on acquired childcare centres, assuming that GEM paid 4x EBIT for those acquisitions, and then making an assumption about any organic growth on top of those earnings - earnings could be forecast with a degree of confidence. Given GEM's earnings have come in below market expectations over the last 18 months, many have attributed this to GEM being forced to pay > 4x EBIT for their acquisitions. We make the following 2 points with respect to this:

GEM acquired 91 childcare centres in 2014 from Sterling Early Education for what they said was a 5.8x EBIT multiple at the time. The strategic rationale for GEM paying above it's 4x EBIT target was to prevent another sizeable childcare competitor from becoming listed on the ASX. This turned out to be a poor acquisition, in part due to Sterling having a large exposure to WA which has since seen a marked economic slow-down post the mining boom. It appears to us that it's this portfolio was likely acquired on 8 - 9x actual EBIT, whilst GEM's acquisition of smaller centres has been maintained at close to the stated 4x EBIT target.

Paying 4x EBIT is a very attractive Return on Invested Capital (ROIC), equating to 25% pre-tax. If GEM were to lift its acquisition multiple to 5x EBIT this would still equate to a 20% ROIC in a record low interest rate environment. In Sterling's case above, a 9x EBIT multiple equates an 11% ROIC. So in terms of capital allocation decisions, GEM is earning a ROIC in year 1 on its acquisitions which is 25% (best case) or 11% (worst case). This is superior to companies such as Amcor, which is lauded as a well-deserved market darling for achieving a 20% ROIC after 3 years!

3. There is a wave of new Childcare supply hitting the market - Looking back over recent years there has been an increase in long day care centre growth, although this looks to have been modest at ~2-4% p.a (see chart below). Our channel checks suggest that there are pockets of over-supply emerging, but this is very location specific, often being in outer-suburban and regional areas. What's also apparent in the below chart is that demand growth can be volatile and childcare affordability pressures on parents are real. If the Federal Government's current 'Familes Package' legislation is ultimately passed by Parliament, this will likely ease affordability pressures for the majority of families from 2018.



Source:

- Supply: Australian Government - Department of Education and Training (solid line), www.mychild.gov.au (dotted line)
- Demand: Australian Government - Department of Education and Training

Looking forward there have been several reports that the number of Development Applications (DAs) with local councils to build new childcare centres have increased. This data is hard to collate given its held by each individual council and it's hard to know what proportion of the DAs will be approved and subsequently become operating childcare centres. For example, we have observed that some developers seek to add value to a proposed development by including a childcare centre within the DA.

Given population growth and the increasing participation rate by families in childcare (as it is increasingly viewed as educational rather than just a baby-sitting service), we note that approximately 200 new centres are required each year across Australia if demand growth continues at its recent 3% p.a. growth rate. And so whilst new supply growth is an issue we are constantly monitoring, we view the current risk to GEM as modest.

4. Bain Capital's arrival in Australia "puts further pressure" on GEM - The AFR reported in August that Bain Capital had acquired the childcare centre group 'Only About Children', which has 34 centres across Sydney and Melbourne with plans for a national roll-out. Whilst a new competitor entering the market is rarely a positive, we note to date Bain have acquired an existing small group of centres (their 34 centres compares to the current national total of ~ 6,900) and they're focused on the premium end of the market. Whilst GEM has a number of premium centres within their portfolio, overall GEM are much more exposed to the mass market, and as mentioned above, demand-supply dynamics are very location specific. It was also reported that Bain paid a material premium (> 20%) in terms of EV/EBITDA vs the multiple GEM trades on.

5. GEM's Auditor resigning is a "red flag" - GEM announced in November 2015 its intention to switch to a new top tier auditor and Ernst & Young was subsequently appointed in May 2016. We view this as part of GEM's move towards improving its corporate governance. HLB Mann Judd officially resigned as auditor in May 2016 after receiving ASIC's consent, which is procedurally how an auditor is replaced for a public company. In ASIC's Regulatory Guidelines* it notes it will not grant auditor resignation approval if there is any concern about the company's management disagreeing with the auditor or shopping for an opinion. So in GEM's case, we see the changing of the auditor as a positive step, rather than being a "red flag". We also note that it's accepted as industry best practice for companies not to retain the same audit firm for extensive periods of time due to independence concerns, and that the Corporations Act mandates that individual audit partners do not oversee a public company's accounts for more than 5 years** for that same reason.

*ASIC RG 26.18 – 26.27, issued 18/06/2015

** S 324DA of the Corporations Act 2001

In addition to the above GEM appointed Mark Johnson as Chairman on 1 January 2016. Mark adds tremendous credibility to the Board in our opinion, he was formerly the CEO of PricewaterhouseCoopers Australia and is currently a board member of Westfield and HSBC Australia. Since joining Mark has also helped attract David Foster to the Board, who was formerly the CEO of Suncorp Bank, which we view as further strengthening the board's capability.

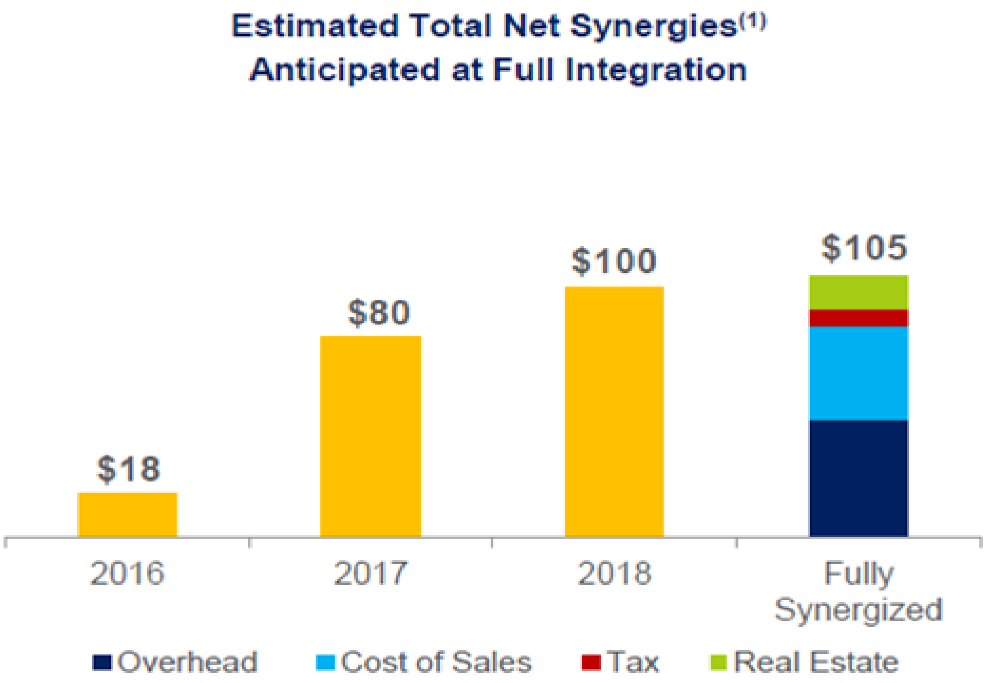
Given our views in regards to the above points, we see the Childcare sector outlook as remaining reasonable. GEM's high dividend yield and valuation discount to several healthcare stocks that have inferior returns and balance sheets, looks attractive to us and we expect GEM to outperform from here.

Iron Mountain

Following the completion of the acquisition of Recall Holdings (REC) by Iron Mountain (IRM) in May, we decided to retain the IRM shares we were given in consideration for the acquisition and used the share price weakness post IRM's second quarter result in August to increase our holding. Post-acquisition, IRM is now the dominant (and only) global document storage and information management provider, operating in industries which continue to grow (despite the 'paperless office' threat) with ongoing industry consolidation opportunities and significant synergies to be realised with the REC integration. We wrote about the REC investment opportunity in our June 2015 quarterly which outlines the attractive aspects of the combined entity.

Despite only having closed the acquisition in May, our confidence in IRM's ability to deliver on its medium-term targets has increased. Already IRM is ahead of schedule on delivering targeted cost synergies from the REC integration and as we wrote last year, we believe that that the cost synergies target is meaningfully below what we believe can ultimately be achieved. Having now had the opportunity to assess the REC business, IRM is assessing additional real estate footprint consolidation opportunities and possible revenue synergies (cross-selling, selective pricing etc.) that are additional to the cost synergies target. We believe that these opportunities are not priced into IRM's current share price.

In our view IRM presents an attractive risk/reward proposition, given its stable earnings profile which generates a mid-teens total return consisting of its current ~6% forward dividend yield that is forecast to grow at ~10% pa over the next 2-3 years. Despite growing dividends at this rate, IRM will actually de-lever their balance sheet and reduce their dividend payout ratio such is the accretion the REC acquisition provides. Further upside exists should IRM's share price re-rate towards its US REIT peers, which trade on 3-5% dividend yields and are growing dividends slower at a slower pace.



Source: Company reports

Offshore Trips

During the quarter we visited the US twice, the UK and Mexico.

US & Mexico

In the US and Mexico we attended numerous investor days and met with companies in the housing, building materials, medical devices, steel and document management industries.

- The slow and steady economic recovery observed in previous trips to the US appears to be continuing and increasingly feels more broad-based; household incomes jumped by 5.2% in 2015 to now be back at pre-GFC levels, although the upcoming Presidential election and conjecture around when the Federal Reserve will start raising interest rates is causing some caution amongst most of the companies/contacts we spoke to.

- The new housing market continues to grow back towards a 50 year average of 1.5m starts with starts forecast to be approximately 1.2m in 2016 and 1.3m in 2017; this next leg of growth increasingly appears to be supported by a faster growth rate in single family starts (a reversal of the trend over past 5 years where multi-family starts grew faster) and some evidence of the pent up demand from 'Millennials' starting to come through to drive starts higher (20% of US population is 18-34 years old with 30% of them living at home, a historic high).

- The decline in oil prices hasn't resulted in a noticeable slowdown in the Texas economy (including the housing market) unlike previous oil downturns given the more diversified Texas economy today. For example, Home Depot's Texas sales are outperforming the company's average and Commercial Metals (a large long steel product producer) hasn't seen any reduction in work or bidding in Texas.

- Prices of flat steel products in the US have softened over the past few months as imports from other countries not captured by the trade cases have increased, highlighting the global nature of the steel industry and that ultimately elevated Chinese steel exports will continue to 'leak' around the world through the path of least resistance, keeping a lid on global steel prices.

- There is a broad expectation that government infrastructure spending will increase in 2017 post the Presidential election, regardless of who wins the presidency. Note that this is independent of the wall that Donald Trump proposes to build along the US-Mexico border in the (unlikely) event that he is elected as President!

- Growth rates in the obstructive sleep apnoea industry have lifted from the bottom-end of a 6-8% p.a growth range to closer to the top end over the last 2-3 years, driven by increasing awareness, increasing use of home sleep testing which is capturing more potential recipients and a reduction in price reductions as the national competitive bidding process for Medicare funded patients reaches full national roll-out.

- Leveraging social media continues to be the dominant theme with large agencies now dedicating material resources to supporting and partnering with the likes of Google and Facebook.

- Mexico continues to emerge as an attractive manufacturing location for medical device companies given the labour cost arbitrage with no reduction in quality of good produced and its proximity to the large US market.

"The 45% tariff is a threat. It was not a tax, it was a threat. It will be a tax if they don't behave. Take China as an example. I have many friends, great manufacturers; they want to go into China. They can't. China won't let them." Donald Trump, Republic Presidential Nominee, 10/03/2016

UK

- In the UK, Management teams are not seeing an immediate impact from Brexit and were on balance, sanguine about the outlook.

- It has taken a while to work through price led deflation in the supermarket, however Supermarkets believe they have broadly addressed pricing architecture compared to discounters in most instances, and are now focused on how best to differentiate in order to drive growth in like for like sales.

- Regulation and the need for efficiencies continues to drive the growth of the fintech space with no noticeable change in the tailwind.

"You're either client facing or you're not... You can't fake it." Jamie Pherous, CEO of Corporate Travel Management, 27/10/15

Outlook

With the unexpected Brexit result a timely reminder that polls and betting odds aren't always correct, the uncertainty in the upcoming US presidential election is an important brake on market optimism; regardless of the likely outcome priced in by the markets. A further source of market concern is the viability of Deutsche Bank. It has traded as low as 0.2x Price to Book Value, and rumours of bond defaults and capital raisings have repeatedly been mentioned in the media. The pressing issue is of counterparty risk and systemic risk that could manifest, which has led to market commentators referring to Deutsche Bank as 'Europe's Lehman Brothers'.

Fundamentally not a lot has changed over the period. The US keeps growing (albeit slowly) with consensus expecting a small interest rate increase by years end. Eurozone economic growth remains flat, with economic conditions in the UK not currently showing any adverse effects from the Brexit vote. China has kept growing impressively, although we fear this growth increasingly reliant on debt fuelled stimulus. Emerging markets are generally weak and Australia remains patchy, although we note that post-election business confidence has ticked up slightly.

We have observed that some quality stocks which demonstrate superior growth which are run by proven management teams have retreated from their recent highs, which has largely reflected overly optimistic short term expectations combined with market uncertainty. Selectively, where we have conviction that the underlying story hasn't changed, we have increased our holdings in such stocks, taking advantage of the lower prices. We expect these portfolio actions will deliver excess returns in the coming quarters as markets begin to appropriately re-rate the businesses. Our focus remains backing above average management teams, running quality businesses, who we expect deliver above market returns regardless of market sentiment.

"How will the interests of 3.2 million Americans estimated to have lost their manufacturing jobs to China be balanced against the hundreds of millions who would have to pay considerably more for imported goods? Not an easy question." Howard Marks, Chairman of Oaktree Capital, 26/05/2016

More information

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

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