Greencape Capital

Greencape Wholesale Broadcap Fund

Quarterly report - December 2013

Performance #	Quarter %	1 year %	3 years % p.a.	5 years % p.a.	7 years % p.a.	Inception % p.a.
Fund return	3.48	24.92	10.87	15.87	7.62	9.75
Growth return	2.80	19.70	4.41	10.60	2.14	4.39
Distribution return	0.69	5.22	6.47	5.27	5.48	5.36
S&P/ASX 300 Accumulation Index	3.37	19.68	8.46	12.33	3.47	5.22
Active return^	0.11	5.25	2.42	3.54	4.15	4.54

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

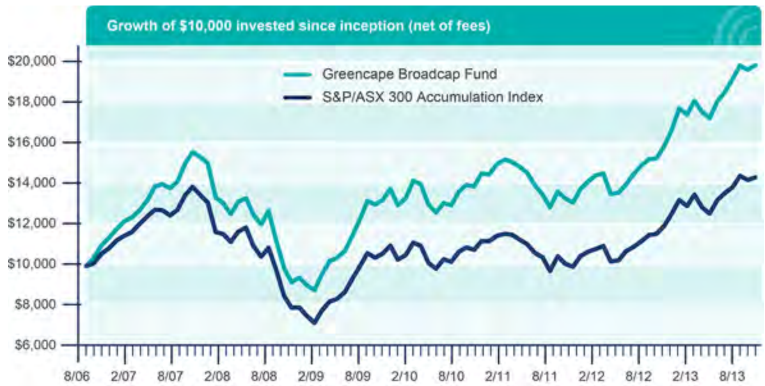
Greencape is an active, 'bottom-up' stock picker. Whilst Greencape does not target any specific investment style and will invest in stocks displaying 'value' and 'growth' characteristics, its focus on a company's qualitative attributes will generally lead to 'growth' oriented portfolios. This is an outcome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

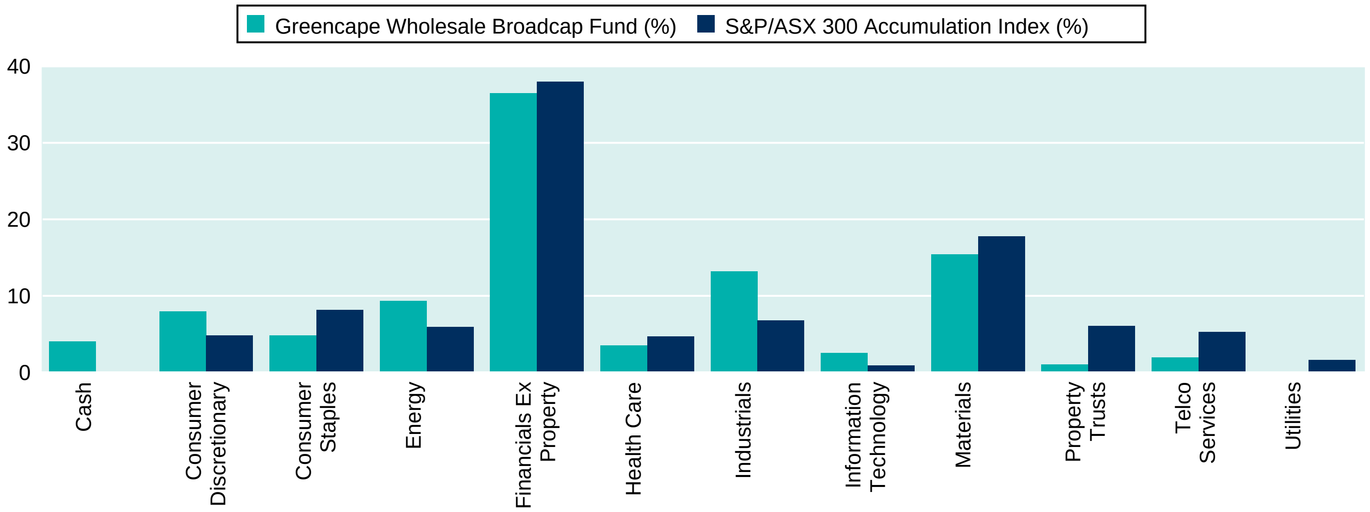


Asset allocation	As at 31 December 2013 (%)	Range (%)
Security	96.00	85-100
Cash	4.00	0-15

Fund facts	
Inception date	11 September 2006
APIR code	HOW0034AU

Fees	
Entry fee	Nil
2012-2013 ICR	1.16%
Management fee	0.95% p.a.
Performance fee	15% of the Fund's gross performance above the Fund's benchmark.
Buy/sell spread	+0.30% / -0.30%

Sector exposure as at 31 December 2013



Fund performance summary

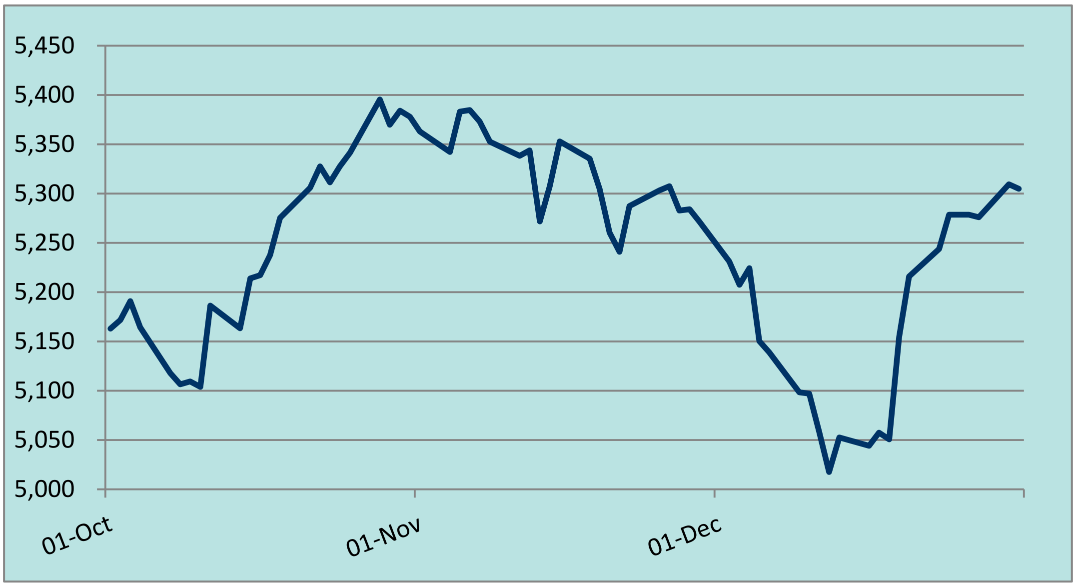
The S&P/ASX 300 Accumulation Index returned +3.37% for the quarter. The fund outperformed the market and delivered a +3.48% return over the quarter.

Market overview

While not repeating the bumper double digit returns delivered in the September quarter, the market still managed to generate another positive result, rounding out a calendar year in which the index gained three out of four quarters. AGM season rolled around in November, which saw a number of companies with cyclical earnings announce profit downgrades. An 'IPO rush' occurred before year end, as over 20 new listings hit the boards during the latter stages of the quarter. In the US, the government shutdown did eventuate in October and the Federal Reserve also began to taper its unprecedented bond-buying program, which the market took positively. The local market underperformed global equities during the period. The local currency also fell on the back of Reserve Bank of Australia's (RBA) jawboning efforts.

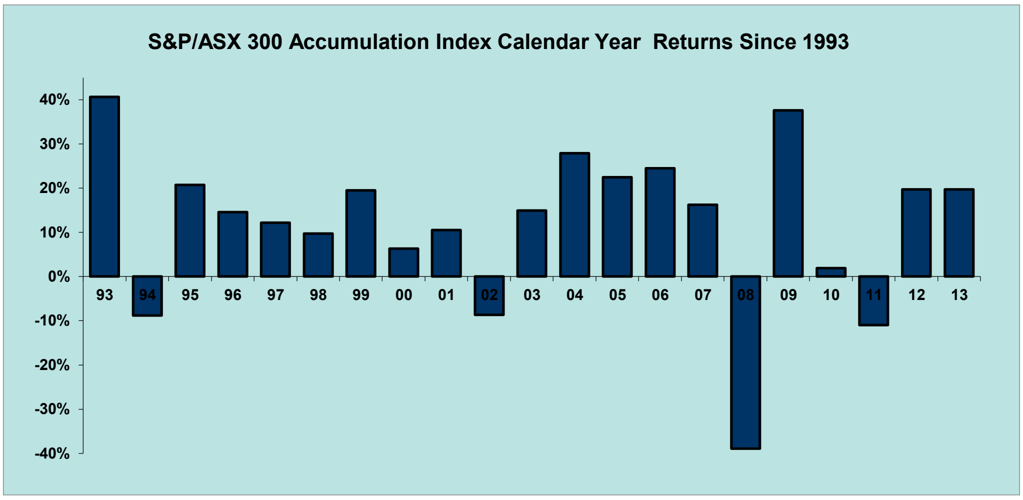
"The highly impressive 30% gain in the S&P500 index last year was primarily driven by multiple expansion, not earnings growth. Thus, PE expansion accounted for an estimated 75% of the index's gain." Christopher Wood, CLSA, 03/01/14

S&P/ASX 300 Price Index



The RBA sat on its hands for all three meetings during the quarter, opting to keep the cash rate at a record low level of 2.50%. The board will not sit again until February. The central bank also took every opportunity possible to talk down the value of the Aussie dollar, with one set of minutes noting the exchange rate was 'uncomfortably high and a lower level would likely be needed to achieve balanced growth in the economy', while in another statement they warned 'it seems quite likely that at some point in the future the Australia dollar will be materially lower than it is today'. The Coalition government scrapped the federal government debt ceiling, instead opting for regular reporting on debt levels to Parliament. The House Price Index data for the third quarter was released in November, and it revealed a jump of 2.2% for the third quarter and 7.7% for the year ended 30 September. In Sydney alone, house prices rose 14.5% for the calendar year, according to RP Data-Rismark. And finally it seems Australia received some political stability, with no change in Prime Minister, unlike the previous two quarters!

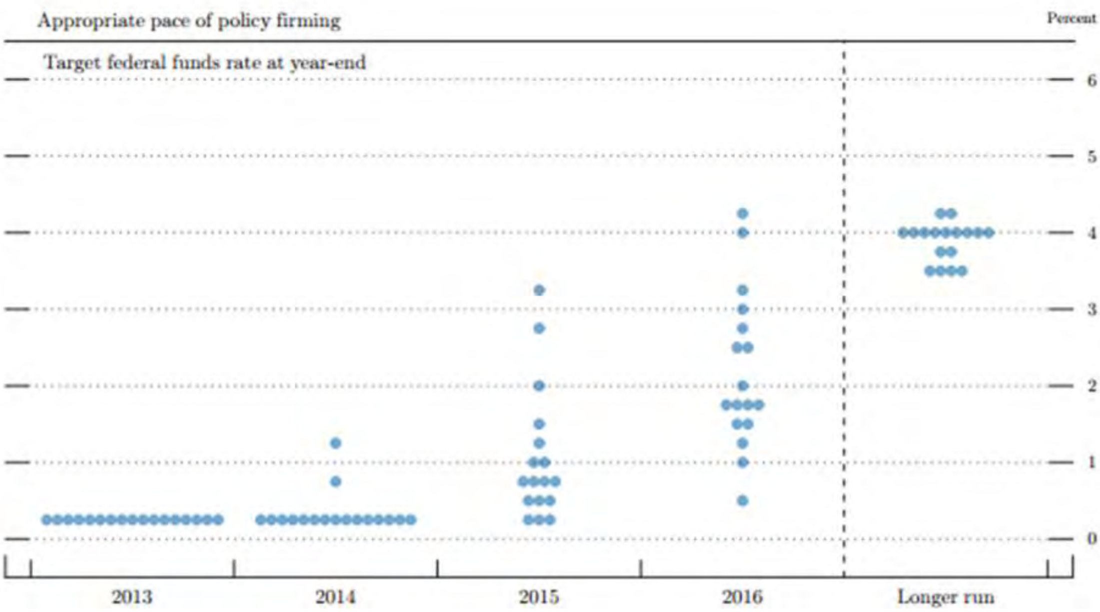
S&P/ASX 300 calendar year returns chart



The conjecture in regards to the 'will they or wont they' decision by the Federal Reserve to taper its stimulus program reached fever pitch during the period. While the market had been debating the timing of the taper since May, the Fed finally announced in December it would reduce both its Treasury and Mortgage-backed security purchases by $5n each to $40bn and $35bn respectively from January. Importantly, the Fed also reinforced its forward guidance of low interest rates, stating that rates will likely stay close to zero 'well past the time the unemployment rates declines below 6.5%'. Aiding the Fed's decision to taper asset purchases was the string of positive economic data which was released during the period. Third quarter real GDP growth printed at a 2.8% annualised rate, easily beating market expectations of 2%. Despite the government shutdown, the October and November payrolls strongly beat market expectations. The US unemployment rate also fell to a five-year low of 7%.

"Patriotism is supporting your country all the time, and your government when it deserves it." – Mark Twain

Below is a chart of separate forecast of FOMC members of the Federal Funds Rates until 2016 and then in the longer term. The median for 2015 is 0.75%, which climbs to 1.75% by the end of 2016, but there is a very broad range of estimates amongst the voting members, so what hope does the market have in predicting this?



Source: Federal Reserve

In China the 'Third Plenary Session of the 18th Communist Party of China (CPC) Central Committee' was held in November. This was a four day meeting which sets the agenda of the economy for the next decade, whereby a large set of reforms were announced. Reforms were announced in sectors such as financial (in particular interest rate liberalisation), land, State Own Enterprise's (SOE's),utility prices and a partial relaxation of the 'one child policy'. Third quarter GDP growth was bang-in-line with consensus at 7.8% year-on-year.

"In TV you don't know what you don't know" David Gyngell, Channel 9 CEO, 25 Nov 2013

Locally, IPO's took the attention of investors during the quarter. In December alone there were 20 IPO's which listed, raising $3.9bn - the highest dollar amount raised in a single month for three years. Debut listing performance was widely varied with some high profile listings having subdued initial trading performances (e.g. Dick Smith and Nine Entertainment) while others rallied strongly. There was also a number of corporate restructings during the quarter. Amcor demerged its Australian packagaging and distribution business, Orora. Brambles also demeraged Recall, its document & records management business. Westfield Retail Trust (WRT) and Westfield Group (WDC) also announced a complicated restructure whereby WDC's Australia and New Zealand business will be merged with WRT to create 'Scentre', making WDC a pure play international developement and management company.

	Dec 2013 quarter	Year
ASX300 Accumulation index	3.4%	19.7%
Best performing sectors		
Telecommunications	5.7%	28.7%
Healthcare	5.4%	25.0%
Financials (ex Property Trusts)	5.1%	34.8%
Worst performing sectors		
Energy	-3.1%	11.5%
Property Trusts	-1.4%	7.3%
Utilities	-0.6%	8.0%

While there was no clear standout sector in the market, Telecommunication Services was the best performing. TPG Telecom rallied 24% during the quarter as it announced it had entered a binding agreement with Telecom NZ to buy AAPY for $450m. The transaction price represented a 6.4x multiple of AAPT's recurring EBITDA.

"Gold has lost 28% of its value in 2013 against the US dollar in a year where the Fed has expanded its balance sheet by US$1.1tn or by US$433bn more than it expanded its balance sheet in the four years of quantitative easing that preceded it. This is one of the most bizarre examples of the perverse behaviour of markets we have seen." Christopher Wood, CLSA, 26/12/13

Healthcare also fared well during the period. CSL settled its pending US antitrust class action litigation for US$64m. The plasma giant also announced a $950m buyback and reiterated FY14 guidance for 7% NPAT growth at its AGM in October. Ansell rallied during the quarter as it announced it has agreed to buy glove manufacturer BSSI for US$615m.

Financials were also strong during the quarter as a number of listed fund managers gained on the back of higher equity markets and strong performance numbers. CBA, the largest index component in the market also outperformed after it released a strong first quarter trading update. QBE fell 22% in the quarter its 2013 profit guidance to ~ 30% lower than market expectations, mainly due to a number of balance sheet write-downs and upgrades to prior-year claim provisions.

Energy was the worst performing sector in the market during the period. Worley Parson's was punished by the market when the Oil & Gas contractor downgraded its underlying earnings guidance for FY14 to between $260-300m, compared to previous guidance of growth on the prior year result of $322m. Oil prices fell during the quarter which impacted performance of stocks in the sector. Caltex however bucked the sector trend and posted a strong gain during the period. It provided a profit update in December, of which the highlight was the company's Marketing division which was forecast to grow 4% for the year. This was particularly notable as the growth for the division in the first half was flat.

Listed property trusts underperformed in a rising market and rising bond rate environment. Despite the restructure, WDC underperformed after it announced it bought the remaining 50% stake of the World Trade Center retail premises for US$800m. Aside from the WDC & WRT restructure, there was other M&A activity in the sector as Dexus and the Canada Pension Plan Investment Board made joint bid to acquire all the units in Commonwealth Property Office Fund (CPA). GPT then made a rival bid of its own. Both bids were for a mix of cash and shares. Dexus and GPT own 25% and 8% of CPA respectively.

Utilities also underperformed the rising market. The only news of note was the sweetening of APA's bid for Envestra, a provider of natural gas haulage services. Envestra shareholders now have the option to receive 0.1919 APA shares for each Envestra share or a combination of cash and equity. Previously, the offer was for 0.1678 APA shares for each share in Envestra.

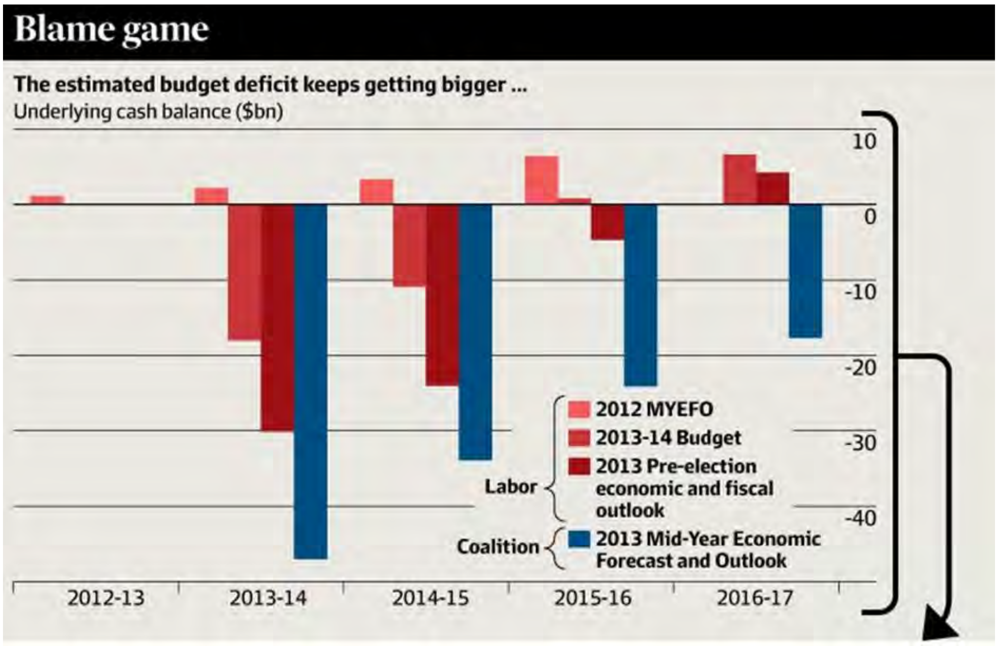
Macro observations

Mid-year budget blowout

The 2013-2014 Mid-Year Economic and Fiscal Outlook (MYEFO) was released by Joe Hockey in December as the first budget of the Coalition Government. Since the Pre-Election Fiscal Outlook (PEFO) was released in August the budgeted deficit for 2013-14 has dramatically increased in size from the predicted $30 billion to $48 billion, with a cumulative $123 billion over the next four years.

In order to mitigate the effects of such a large deficit, the government warns that all Australians are going to have to be ready for reductions in government spending to which they have become accustomed. This may prove a difficult pill to swallow for the voting public.

The full budgeted deficit and predictions prior to the PEFO are displayed in the table below:



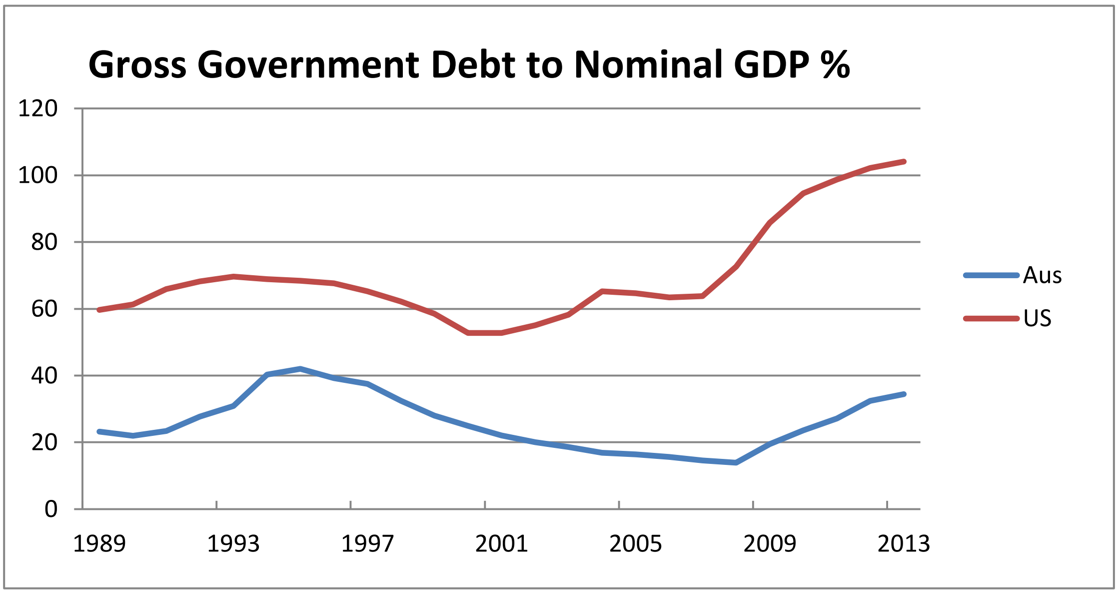
Source: AFR

While at face value this revision suggests that the economy is in a far weaker state than in August, it's more likely due to a more conservative set of assumptions and only slightly softer economic environment, with the government choosing to take the large fiscal blow early in its term with the ability to still blame the previous government.

The total cumulative deterioration over the forward estimates of the deficit is $68 billion, taking the prediction to $123 billion. Treasury estimates $54 billion of the budget deterioration is due a reduction in tax receipts related to economic circumstances outside the government's direct control, and that the remaining $14 billion is directly related to government policy decisions that reduced revenue and increased spending. Treasury largely attributes these policy decisions to addressing the funding shortfall the former Government left for its policy relating to offshore processing of illegal maritime arrivals ($1.2 billion) and providing the Reserve Bank of Australia with a grant to strengthen its capacity to withstand future shocks and financial crises ($8.8 billion). The latter is expected to help the RBA in its efforts to weaken the local currency should it choose to intervene.

"Budget prudence is as much about resisting new spending as it is about the quality of existing spending." – Joe Hockey, Treasurer, 17/12/2013

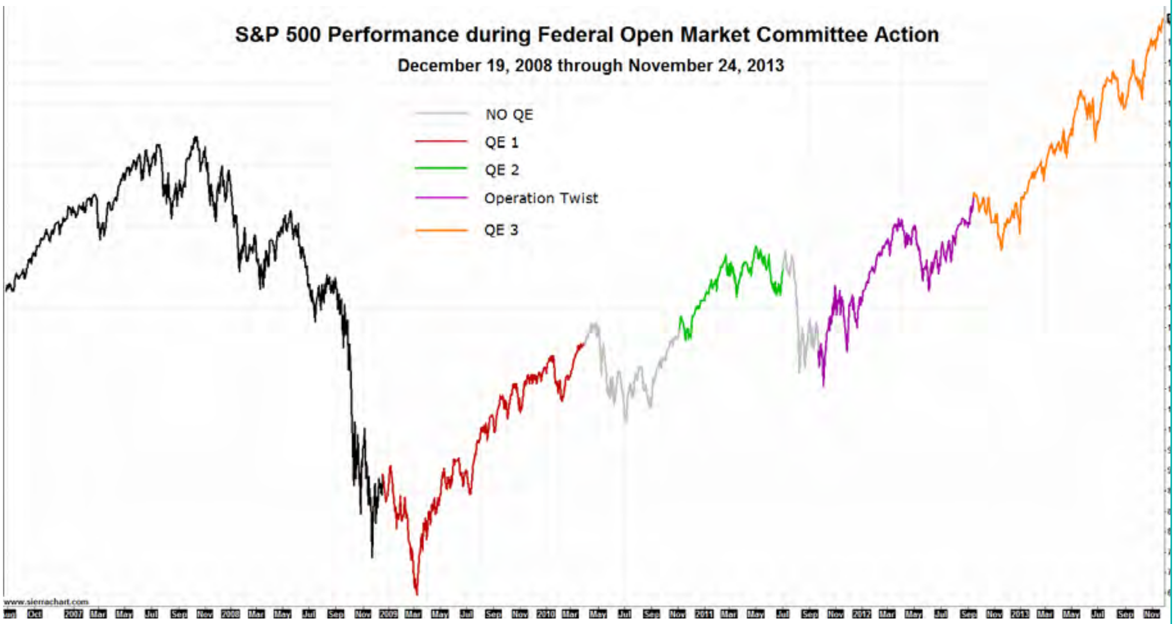
With the debt ceiling being abolished, paired with the magnitude of the fiscal blowout, it is not unimaginable that we may start to run a 'structural deficit', similar to the US government but (hopefully) on a much smaller scale! Below we can see Australia's gross debt to GDP ratio has more than doubled in the past five years from 14 to 34 percent, and is set to further deteriorate based on Treasury's forecasts as detailed above.



Source: OECD

Quantitative Easing and Income Equality

Since the US Federal Reserve began their large scale asset purchasing program, the effect on the US share market has been profound. As we can see below, each successive round of Quantitative Easing has sent the market surging higher, and conversely the market has fallen each time it has ended. The question remains will this time be any different? And who exactly is benefitting from the large scale flow of capital into the market?



Source: Deutche Bank

According to Fed data, the richest 5 percent of Americans own 60 percent of the nation's individually held financial assets. This includes 82 percent of the individually held stocks and more than 90 percent of the individually held bonds. Therefore by boosting prices of financial assets, the Fed is making the rich even richer. Whilst QE may be boosting Wall St, its effects on Main Street are vastly different. Mohammed El Erian, CEO of the world's largest bond fund, PIMCO, suggests by his calculations that the Fed has created and spent $4 trillion dollars for a total return of 25 basis points additional GDP (only $40 billion).

Looking at the average family income in the US between 2002 and 2012 (excluding capital gains and adjusted for inflation), the bottom 90% of families actually experienced a decline in real income, whilst the top 10% saw gains, which were greater as the analysis moves closer towards the top 0.01%.

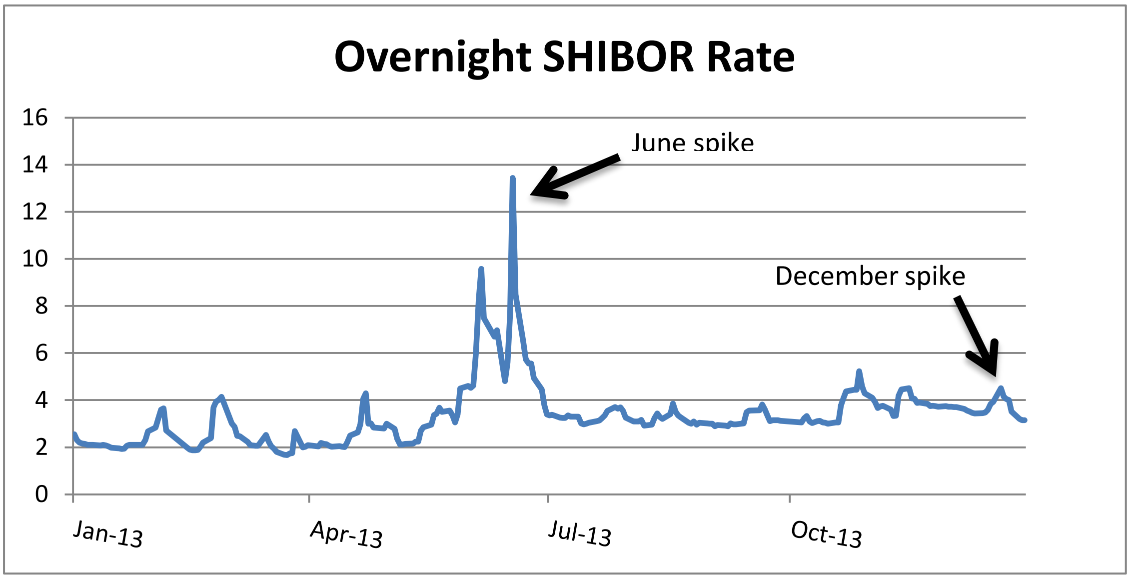
"It may take years but the whole culture of credit and debt will fail. This is reality. We just do not know how or when. In the end, the consequences of monetary folly have not been addressed but only postponed. The errors have not been cleared but merely covered up with money and false accounting. Money printing can buy time but not wealth. All roads lead to impoverishment of some sort. The only question that remains is what road will be taken." – Tony Deden, Edelweiss Holdings, 25/11/2010.

Chinese Capital Flows

We continue to observe large capital outflows from China. Evidence of which is seen in growth in Chinese gambling turnover (in Macau, and plenty of other casinos around the world), property acquisitions (think trophy properties like Manhattan, London, Paris, Sydney, Vancouver, but also in Melbourne suburbs like Kew, Balwyn, and Toorak). A recent survey of investment strategies of affluent Chinese, showed a very large bias to investing outside of China. Indeed the same survey showed a large percentage wish to eventually emigrate and Australia ranked number 2 on their list, after Canada. Such trends with capital flows can be important influences to the Chinese economy, especially if they were to coincide with foreign capital outflows. Capital flows (essentially out of local banks and towards foreign markets) have been described as a 'walk' rather than a 'run' on the banks but future government regulation to restrict such capital flows is not out of the question in our view. We would expect a negative market response to such actions if they were to occur, particularly in the gaming and property sectors, since they've been the biggest beneficiaries to date.

One of the drivers of the capital outflows is the chase for attractive returns. Bank deposit rates are regulated in China, and are artificially low to encourage banks to lend at lower rates. What has emerged (largely in the last decade) is 'shadow banking', which we spoke about in previous quarterlies, where intermediaries borrow from banks at attractive rates then on lend (mainly to cash strapped corporates) at very high rates, reflecting the high risk of non-performing loans (NPLs). Figures show a rapid growth in 'shadow banking'. This lending growth is coinciding with lower returning projects , and indeed increased borrowing to pay for completion of projects where returns have been lower than expected (e.g. property not sold or leased) or even new borrowing to repay old loans when they come due.

"The number one indicator of fragility is leverage. It can be operational or financial. Leverage corresponds to people's overconfidence about the future." Nasssim Taleb, September '13



Source: Bloomberg

A growing trend of borrowing from non-bank lenders has many parallels to the lead up to the GFC in the US. We observe that the Chinese authorities are genuinely concerned about this, and have stated (since the Plenum meeting in November) that credit growth had to slow, and lending to be targeted at higher returning projects. Indeed, last June, the Chinese Central Bank (People's Bank of China, PBOC) refrained from providing adequate liquidity into the market to match demand; the result was a sharp increase in inter-bank interest rates. The PBOC eventually responded, announcing they will use tools to safeguard stability in money markets which would ease the liquidity squeeze. Again, in December, the PBOC allowed a reduction in liquidity (as a key means of signalling it's lower credit growth objective, forcing credit rationing). The 'experiment' did not last a week before the PBOC intervened and injected liquidity, as borrowers scrambled for funding. We consider the repeated 'experiments' and signalling are important indications that issues are emerging that are concerning the Chinese authorities, key of which is lending growth that supports low returning investments. As with most economies, a cycle of non-performing loan recognition is considered inevitable. The issue is when, and how bad the downturn in the cycle will be. Another issue to consider is whether current actions will make future problems harder to deal with in the future.

Micro observations

Overseas trips

During the quarter we visited the US, Asia on two occasions and UK/Europe. Some of our observations were:

UK/Europe

- Demand in both in the UK and Continental Europe for logistics is on the upswing and is gaining momentum due to a combination of under investment in prior years, increased economic activity and continued strong demand for online retailing.
- Property valuations are firming with more evidence of this in recent transactions. Commercial agents are now citing numerous buyers and better than expected bids.
- The hi-tech sheds being built for online and multichannel retailers require specialist developers that have land in the right locations ready to go, meaning that consents and planning issues are dealt with efficiently. Furthermore, given the rapid ramp up in demand for online related supply chain, a track record of on-time delivery is important for developers to win work.

"There are 100 cities with more than a million inhabitants in China with no premium car dealers at all, so this shows the huge potential we're having in this country." Karsten Engel, Head of BMW China, 11/07/2013

Goodman Group built warehouse – DHL and Amazon co-located. Sites need flexibility, whilst land in the right area is key. See image below.

Asia

- In what could be the first sign that China is opening up its economy, the Shanghai Free trade Zone was launched in the September quarter. Whilst it will initially operate on a trial basis, hopes are high that it will materialise into a broader initiative.
- As an indicator of the strength of the Chinese labour market, a 20% pay rise is seen as being the tipping point to get people to change jobs.
- The new Chinese government has been received well by the corporate sector and seen to be taking an early an aggressive stance on corruption and pollution
- Pollution remains a significant issue. Some perceive this to be a direct result of subsidisation and regulation of energy prices.
- A reversal of history where labour was cheap and capital expensive, means Electronic Gaming Machine's will play an increasing role in Macau casinos over the long term. One casino described them as a 'sleeping giant'.
- Given the combination of infrastructure development, 6 major casinos under construction simultaneously and restrictions around imported labour, there is a risk many of these projects will be delayed.

Outlook

We are observing consistently improving economic data in the US, whilst the first phase of tapering is has now been announced. This coupled with gains in both equity and housing markets and the subsequent wealth affects is positively influencing corporate and consumer sentiment. The resultant strength and momentum in the USD is evident. Clearly companies with drivers dependent on US economic growth are now experiencing positive operating trends. It's been a long time since this environment has been sustained, however. The recent years of flat conditions, and the associated productivity focus suggests operating leverage is not to be ignored.

European economies are observed to remain flat, albeit early signs of improvement are observed in the UK with specific sectors and stocks expected to benefit in coming quarters.

The Chinese economy appears to have stabilised after its recent slowdown in growth. Structural issues such as rapid growth of non-bank lending to low returning assets (and rising non-performing loans risk) plus capital flows exiting China (latest example is FOX divesting its China pay TV business) have yet to find policy solutions to allay concerns. We conclude the short term outlook for China (and Asian) leveraged stocks looks fine, but we remain cautious of the medium to longer term outlook given the uncertainty.

"If you haven't done the work on a position and it moves against you, your emotions take over, and when your emotions take over, you lose every time." Kyle Bass, Hayman Capital, 05/12/13

Domestically, post-election stability, a weaker AUD and low interest rates are acting to provide a base to consumption. The approaching headwinds of fiscal tightening and slowing income and employment growth are expectations we closely monitor.

The divergent performance of different geographies lends itself to stock picking. Management skill and business franchise strength are expected to become more valuable in coming quarters. The scarcity of good investment ideas implies such combinations can be expected to deliver attractive shareholder returns.

"You see the world markets switch from growth to dividend, from large to small stocks, from high beta stocks to low beta stocks. It really teaches us that this is how complicated the markets are, so be careful."
David Haines, The Portland House Group, December 2013

More information

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

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