Greencape Wholesale High Conviction Fund

Quarterly report - December 2015

Performance #	Quarter %	1 year %	3 years % p.a.	5 years % p.a.	7 years % p.a.	Inception % p.a.
Fund return	6.00	2.85	11.00	8.12	11.52	8.96
Growth return	4.96	-9.46	2.16	1.50	5.73	2.64
Distribution return	1.04	12.31	8.84	6.62	5.79	6.32
S&P/ASX 200 Accumulation Index	6.48	2.56	9.19	6.97	10.01	5.10
Active return^	-0.48	0.29	1.80	1.15	1.52	3.86

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

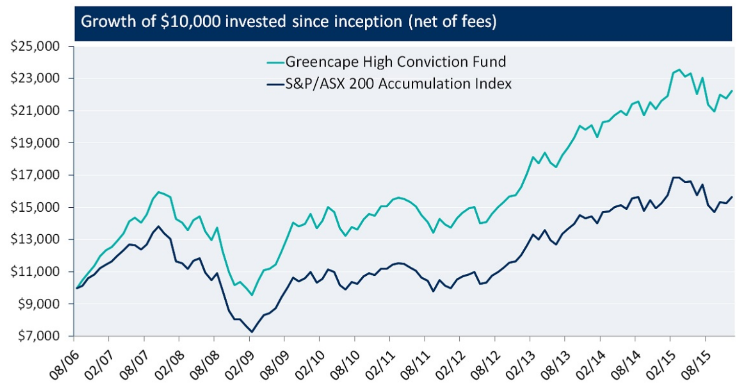
Greencape is an active, 'bottom-up' stock picker. Whilst Greencape does not target any specific investment style and will invest in stocks displaying 'value' and 'growth' characteristics, its focus on a company's qualitative attributes will generally lead to 'growth' oriented portfolios. This is an outcome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

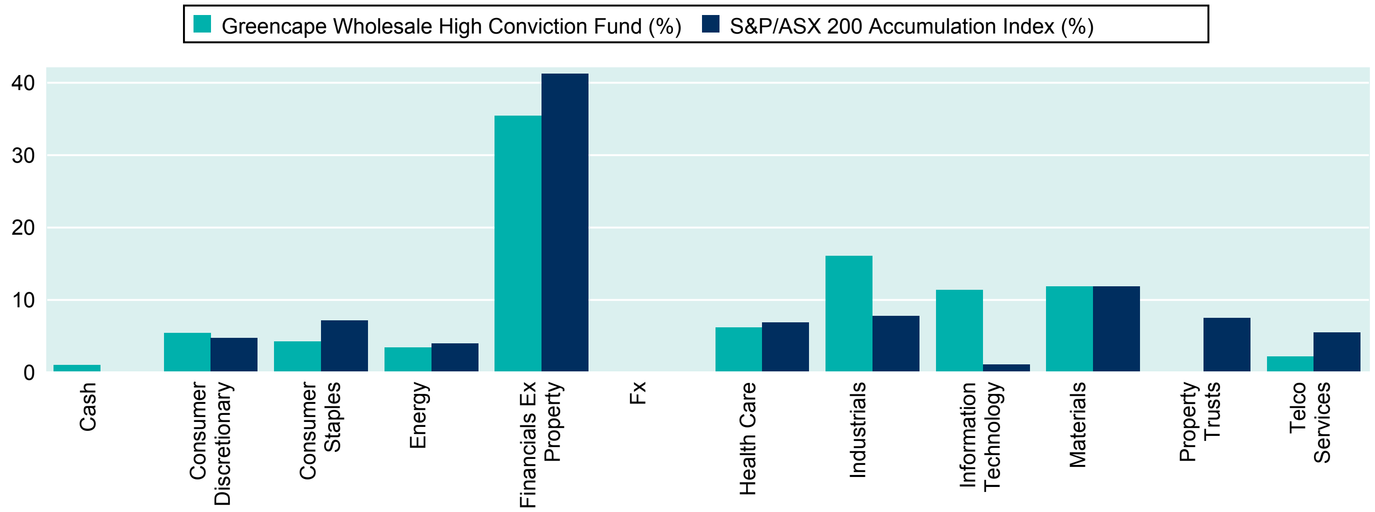


Asset allocation	As at 31 December 2015 (%)	Range (%)
Security	99.03	85-100
Cash	0.97	0-15

Fund facts	
Inception date	11 September 2006
APIR code	HOW0035AU

Fees	
Entry fee	Nil
2014-2015 ICR	1.14%
Management fee	0.90% 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 200 Accumulation Index).
Buy/sell spread	+0.20% / -0.20%

Sector exposure as at 31 December 2015



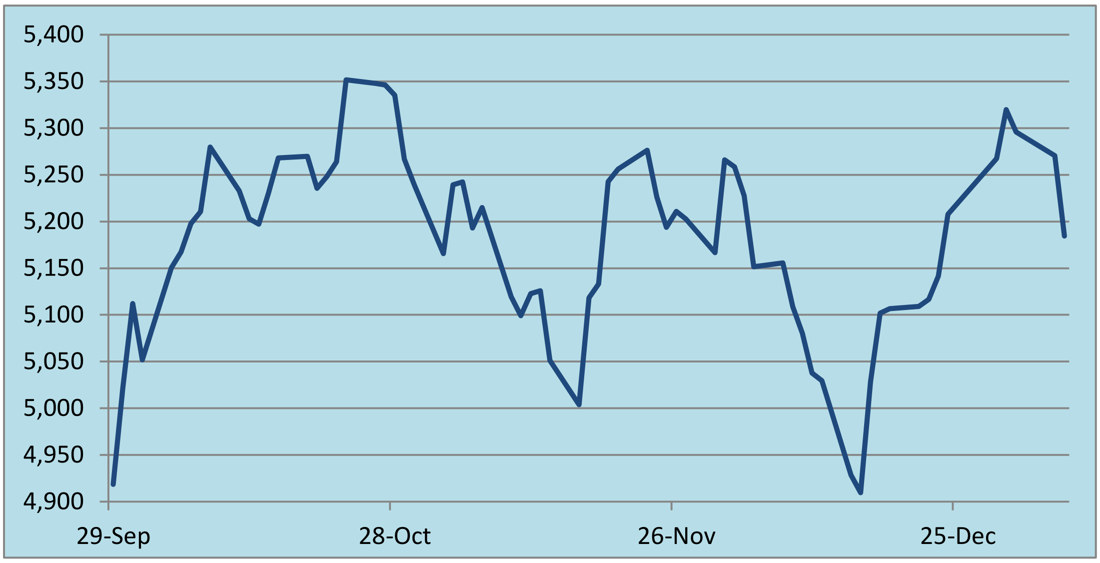
Fund performance summary

The S&P/ASX 200 Accumulation Index returned +6.48% for the quarter. The fund underperformed the market and delivered a +6.00% return over the quarter.

Market overview

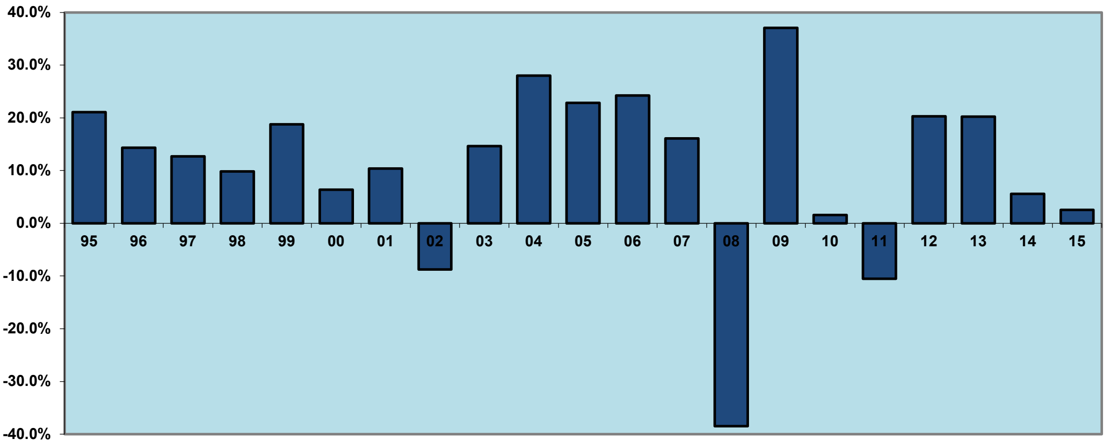
The market endured a turbulent quarter but the accumulation index (with dividends reinvested) managed to grind out a small positive return for the calendar year. The market continued to gyrate around the expected action of central banks, meanwhile AGM season, falling commodity prices and some high profile corporate missteps kept market participants busy during the period.

S&P/ASX 200 Accumulation Index



Source: Iress

S&P/ASX 200 Accumulation Index Calendar Year Returns Since 1995

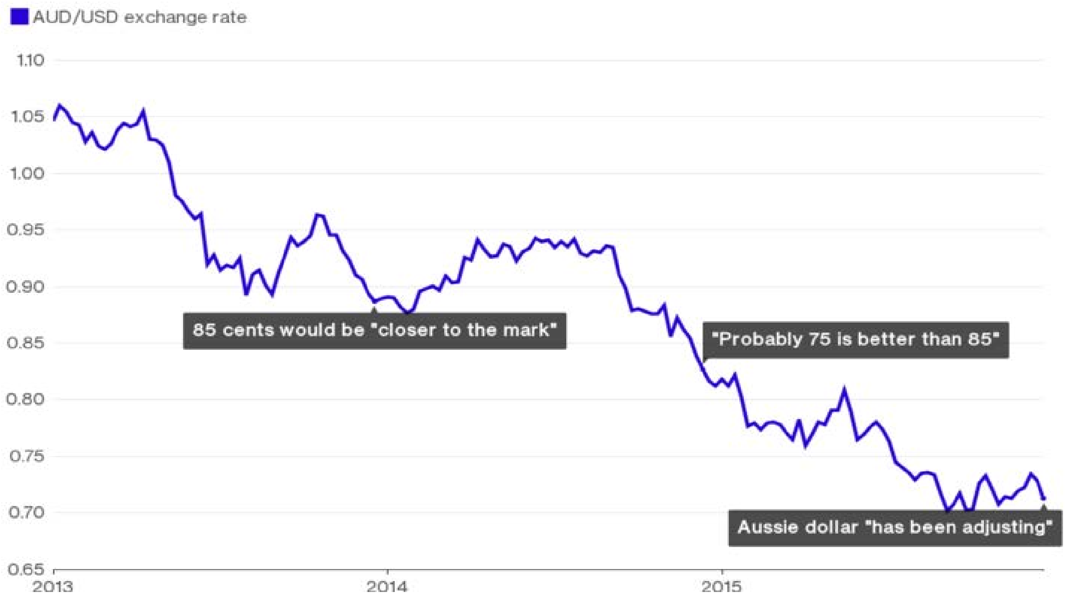


Source: Iress

As expected the RBA held rates at all three meetings, keeping the target rate at the historical low of 2.0%, where it has been since May. A weaker than expected CPI print in October (1.5% year on year growth, versus market expectations of +1.7% and RBA target range of 2-3%) saw an increased likelihood of a rate cut during the period, however two incredible jobs data prints saw the end of any rate cut speculation. The economy added 59k and 71k jobs in October and November respectively compared to economist expectations of a 15k increase and 10k decrease in job numbers. Conversely, private capital expenditure, driven by the resources sector, fell 20% year on year in Q3, the worst fall on record.

"Were a change to monetary policy to be required in the near term, it would almost certainly be an easing, not a tightening." Glenn Stevens, Governor of the RBA, 05/11/2015

The RBA usually sets a level in the meeting minutes for which it thinks the AUD should be trading, however Governor Glenn Stevens refrained from doing so, indicating their comfort with the current level.

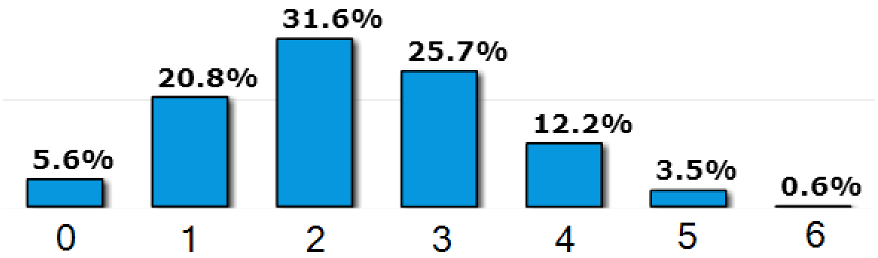


Source: Bloomberg

As expected, the United States Federal Reserve (Fed) finally raised the rate corridor above the lower bound of zero, where it has been since December 2008. The Federal Open Market Committee (FOMC) (the branch of the Fed that sets monetary policy) signalled it expected to raise rates a quarter of a percent four times in 2016, however the market implied probability points to expectations of only two rate hikes this year.

"I think negative nominal interest rates are something the Fed might consider." Ben Bernanke, Former Chair of the Federal Reserve, 16/12/2015

Futures Implied Probability Distribution for Number of Rate Increases in 2016

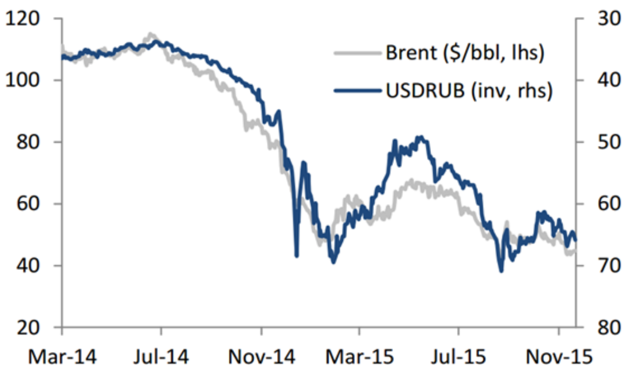


Source: CME

The European Central Bank (ECB) cut its deposit rate by 10 basis points to -0.3% and extended its asset purchasing program by six months. This was taken as a negative by global markets as the expectation was for an increase in the monthly rate of the asset purchasing program, which currently stands at €60bn per month. Elsewhere, Japan fell back into recession, posting two consecutive quarters of negative growth despite the unemployment level falling to a 20 year low of 3.1%. Chinese economic data continued to match market expectations, as Gross Domestic Product (GDP) grew by 6.9% in Q3. Meanwhile the corruption crackdown continued to hurt Macau gaming revenues, as the region's GDP fell 21% in Q3. In December, we noted that the China Daily (a state owned newspaper) published an article which detailed that state officials sought to explain dramatic drops in economic growth in their local area by admitting they fabricated the previous higher growth figures.

Russia's currency appears closely aligned with a falling oil price, putting fiscal pressure on the government and other countries which are heavily dependent on energy revenues to balance their budgets.

Can you tell which is which? RUB vs. Brent

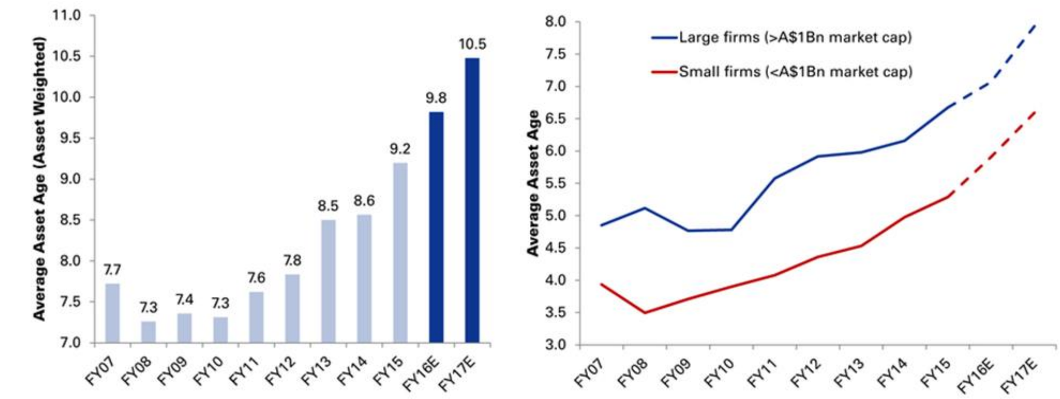


Source: Deutsche Bank, Bloomberg Finance LP, Haver

Domestically, October brought the annual AGM season which saw a number of companies update their earnings guidance for the first time since the August reporting period. A2 Milk upgraded its earnings forecast, driven by better than expected infant formula sales. The number of downgrades during the period outnumbered upgrades however. Dick Smith downgraded its full year earnings guidance by 14% at its AGM in October, before booking a $60m impairment against inventory in November. The company eventually entered voluntary administration in January. Spotless Group also posted a profit warning in December, despite reiterating full year guidance at the company's AGM in October, citing delays in contract commencement times and anticipated contract wins not materialising. Slater & Gordon also withdrew its earnings guidance, citing the unknown potential impact from a UK government review into restricting the rights of people injured in road traffic accidents to obtain compensation.

In recent years there has been an increasing trend for companies to drive capital management outcomes in favour of generating near term earnings and dividends, instead of reinvesting earnings for future growth. We observe below that as a result, the average age of fixed assets has been pushed out as firms delay capital expenditure to run lower depreciation and amortisation.

Exhibit 1: Since FY10 the average age of fixed assets held by Industrial firms has increased by 2 years.
Asset Age = Accumulated Depreciation / Current Period Depreciation.
Sample: All Industrial firms covered by GS Research with >6-years of data



Source: Goldman Sachs Global Investment Research

Source: Goldman Sachs

"Thirty years from now there will be a huge amount of oil - and no buyers … The Stone Age came to an end, not because we had a lack of stones." Sheikh Ahmed Zaki Yamani, Saudi Oil Minister, 2000

"If you are prepared to take a bit of a risk and if you are prepared to take a punt in innovation, then there is a tax incentive for you…We need to unlock more capital. There are some very big policy levers we can pull to ensure that more capital is invested into innovation in this country." Wyatt Roy, Assistant Minister for Innovation, 27/11/2015

	Dec 2015 Quarter	Year ended Dec 2015
ASX200 Accumulation Index	6.5%	2.6%
Best performing sectors		
Consumer Discretionary	13.4%	18.0%
Healthcare	12.4%	15.8%
Financials ex Property Trusts	11.6%	4.7%
Worst performing sectors		
Materials	-7.4%	-15.7%
Energy	-1.2%	-27.3%
Telecoms	0.7%	1.8%

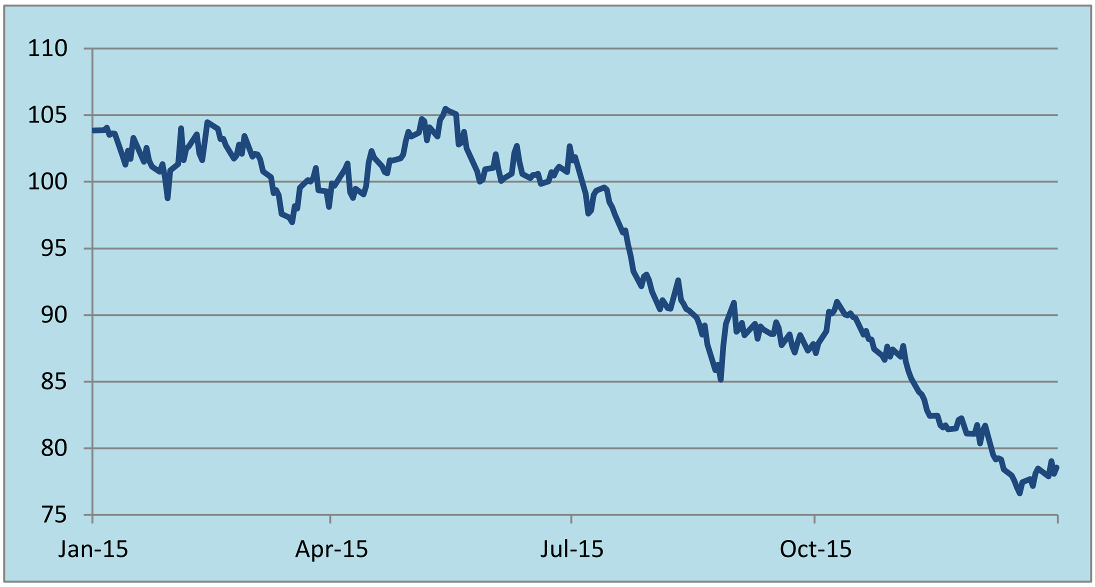
Consumer Discretionary stocks fared well, as outdoor media stocks continued to outperform. During the period, the Outdoor Media Association announced industry spend in November increased 15% compared to the prior corresponding period as digital boards continued to be rolled out. Ooh!media and APN Outdoor both announced profit upgrades while QMS announced the acquisition of iSite in New Zealand. Healthcare stocks as a sector also beat the broader marker. CSL announced a new USD$1bn buy-back at its AGM in October while Ramsay Healthcare re-affirmed earnings guidance at its AGM, the tenth year in a row it has done so.

Energy and Materials stocks continued their extended streak of underperformance and there were some interesting developments during the period, particularly in the energy sector. In October Santos announced it received an all-cash takeover offer for $6.88, which it rejected. In November the company announced the outcome of its strategic review, being to reduce net debt by $3.5bn, which included an entitlement offer at $3.85. Origin also announced it purchased oil puts for the FY2017 at a cost of $82m to reduce the company's exposure if the oil price was to fall further.

"We will have so much winning if I get elected you may get bored with winning. Believe me. We are going to start winning big league." Donald Trump, 2015

Commodity prices continued to fall during the quarter, as shown below by the movement of the Bloomberg Commodity index which tracks a broad basket of commodities.

Bloomberg Commodity Index



Source: Bloomberg

We thought this was an interesting snippet from UBS:

> ‘Back in 2009, both BHP and Petrobras were worth more than Apple. Now, Apple could theoretically buy both businesses with net cash and still have money left over to pick up Glencore, Newmont, Barrick Gold, Anglo American and most of Goldcorp.
>
> The combined market cap of Apple (US$650bn) and Google (US$450bn) is now greater than the total mkt cap of all mining stocks in the world...which has fallen below US$1trillion (US$934bn).’

In November, BHP advised that two dams collapsed in its 50% owned JV iron ore operation in Brazil. As a result, a significant amount of mine tailings were released and caused significant environmental damage, with 17 confirmed fatalities thus far. Below are aerial views of the mine waste as it reached the Atlantic Ocean.

Source: The Guardian

"The big oil spill in the Gulf of Mexico is a good precedent of how to agree on funds for environmental and socioeconomic recovery. That’s our goal.” Rodrigo Vieira, Chief Prosecutor, Esprito Santo, Brazil, 01/12/2015

MYEFO & stock impacts

In December the Federal Government released its Mid-year Economic and Fiscal Outlook (MYEFO), which is an update of the forecasts provided in the budget in May. The MYEFO, like the budget, is of particular interest to companies which derive a large amount of their earnings from government funding. Much of this revenue can disappear at the stroke of a government pen, which is more likely to occur when the government is looking to plug revenue holes and cut expenditure when growth is moderating.

The MYEFO saw the government cut its growth forecasts as detailed below:

	Outcomes	Forecasts			
	2014-15	2015-16		2016-17	
		Budget	MYEFO	Budget	MYEFO
Real GDP	2.2	2.75	2.5	3.25	2.75
Household consumption	2.5	3	2.75	3.25	3
Dwelling investment	7.7	6.5	8.5	4.5	2
Total business investment	-6.3	-7	-9.5	-3.5	-4
Mining	-17.3	-25.5	-26	-30.5	-25.5
Non-mining	1	4	-0.5	7.5	4.5

Source: Fairfax

"It's a big job to turn around spending increases that occurred over many, many years, structurally impacting the budget." Scott Morrison, Treasurer, 15/12/2015

Other highlights include:

- A $2bn widening of the 2015-16 deficit compared to what was forecast in May to $37.4bn;
- Revenue forecast cut by $35bn, which includes a $7bn fall resulting from lower iron ore prices;
- Iron ore prices cut to USD$39 per tonne from USD$48 (the WA state government forecast USD$120 last year); and
- Gross debt forecast to reach $650bn in 2025-26 (19% of GDP)

The line item most relevant to Australian listed companies was the saving of $650m over 3 years from changes to pathology and diagnostic imaging funding. The savings are being derived from the removal of bulk-billing incentives for pathology services, aligning bulk-billing incentives for diagnostic imaging services with those that apply to GP services and reducing the bulk-billing incentive for MRI services. These changes come after the government set up a Medicare Benefit System (MBS) task force to review the 5,700 items on the MBS list in April 2015.

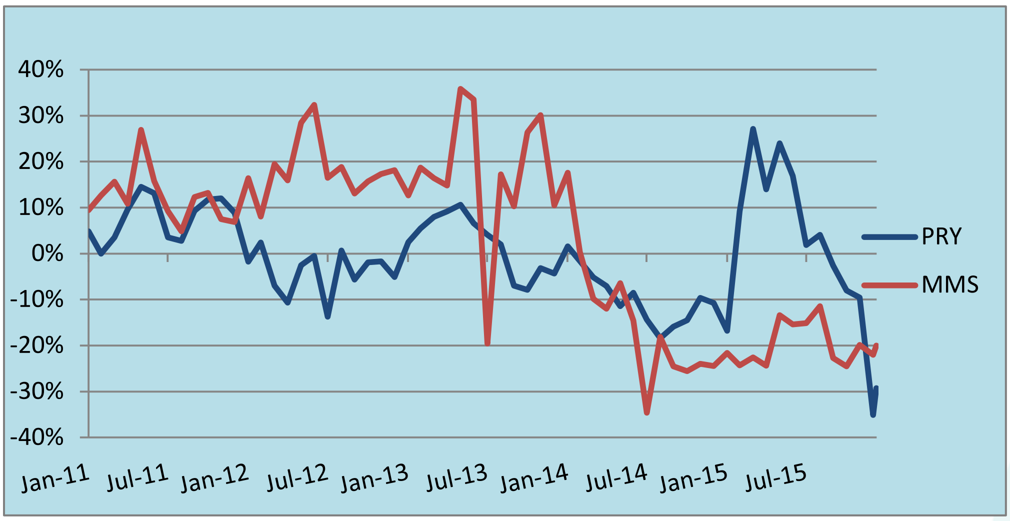
At the time of the announcement, Primary Healthcare and Sonic Healthcare which both provide pathology and diagnostic imaging services fell 10% and 6% respectively within seconds.

PRY intraday chart 15/12/2015

Source: Bloomberg

Interestingly, Primary Healthcare (PRY) traded at a forward earnings multiple as high as 21x in early 2015 (the market trades at around 15x), before drifting to a market multiple. After the MYEFO announcement and subsequent earnings downgrades, the stock was de-rated to a 11x, a 30% discount to the market. When a stock's multiple contracts, it means the price fall is greater than the earnings downgrade (conversely if a stock is downgraded but the price doesn't fall, the stock actually re-rates upwards). The heightened regulatory risk surrounding Primary's revenue meant that the market was no longer willing to pay a premium (or even par) for the company's earnings.

1 year Forward P/E Premium vs ASX200



Source: Bloomberg

In 2013, McMillian Shakespeare (MMS) which provides salary packing and novated leasing services, was de-rated from trading at a market premium of 22x to 10x after the Rudd Labour government proposed to abolish the statutory method of calculating Fringe Benefits Tax, a proposal if enacted would've significantly impacted the earnings of the business. After the proposal was withdrawn, MMS bounced back but the earnings multiple over time has fallen back to 12x. Interestingly, a number of salary packing companies have listed in Australia in the past 24 months.

As revenues from sources such as iron ore production fall, the government is increasingly looking to plug holes in the budget to stop the deficit from ballooning further. It appears the market now justifiably demands an earnings multiple discount for companies whose earnings are at risk from a change in government policy.

Link Administration Holdings Ltd (LNK)

In late October 2015, Greencape participated in the Link IPO, with the stock up over 15% on the issue price as at early January 2016. Link is a scale provider of fund administration services to the Australian superannuation industry. They also provide various shareholder services to listed companies, however it's the funds administration business (which contributes around 75% of group revenues) which is the key earnings driver. Link should be characterised as a relatively defensive stock given the sticky, contracted revenue and the difficulty in switching fund administrators. Revenues are generally on a per member basis, hence there is limited leverage to FUM balances but rather the ability of the funds to attract incremental members (organically or inorganically).

Superannuation accounts can be administered either in-house or outsourced, and Link has the dominate share of the growing outsourced market. Industry funds in particular are increasingly considering an outsourced model as compliance costs continue to rise and investment in technology is required in order to stay relevant, highlighting the benefit of being a scale provider. It's also not just the capital expenditure cost of IT investment, but the Management expertise in delivering a robust platform solution that is often lacking. Compared to peers, Link has a robust technology platform and strong Management expertise in funds administration and is therefore well positioned to benefit from the structural changes impacting the funds administration industry. As Link looks to further consolidate the market, adding incremental members is likely to provide scope for solid operating leverage, whilst providing an efficient and cost effective service offering to their fund clients.

We note that the stock trades on a material premium to the market (28x FY16e), however this can be explained by the strong expected earnings growth over the next 3 years underwritten by the recent acquisition of Superpartners (which as a standalone entity struggled to execute on its technology solution and was unprofitable). We expect synergies to be in excess of $90m cumulative with the peak run rate coming in FY18, as Link integrates the various funds under the Superpartners banner. Synergies are likely to come from scale operational efficiencies, legacy system retirement, vendor consolidation, head office rationalisation and further post migration optimisation benefits. Given the nature of the integration (i.e. you can only turn off the old system once you're comfortable everything is working fine post migration) it's important to note that the synergies are likely to be back end dated. Management expect post integration margins to increase back to where group margins were prior to the Superpartners acquisition, despite the business likely to be twice the size in terms of revenue. We think there's an element of conservativeness built into this assumption in light of the likely fixed vs variable cost base of the business. Our channel checks via a broad range of industry contacts from IT executives and project implementation managers through to CFOs and Board members across our own client base and various industry participants (ex Superpartners, ex Link, various current smaller competitors and other corporate fund administrators) qualitatively supports our analysis that the upside in earnings from good execution is material. Furthermore, the Management team at Link are held in high regard, which we feel also helps de-risk the execution process in the coming years. Going forward we expect Link to generate good earnings growth, and with much of it under its control, it should provide less volatility in earnings compared to the broader market.

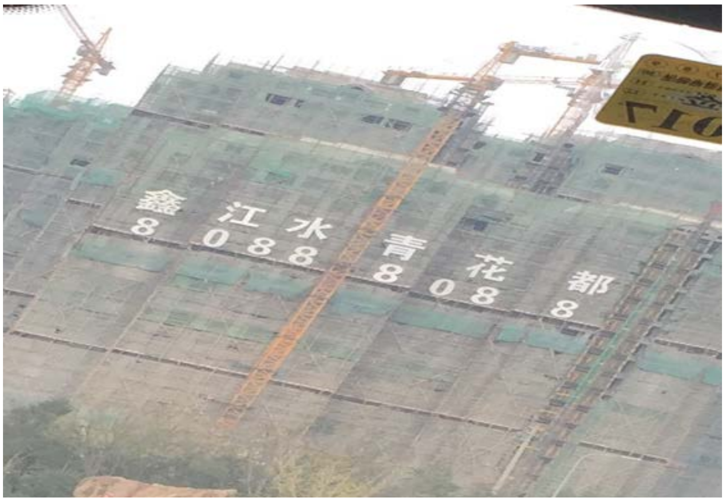
Overseas Trips

This quarter we travelled to the US & New Zealand twice, Europe, China, Hong Kong and Singapore.

China observations

- The compositional shift occurring from heavy industry to services was clearer in this trip compared to previous visits.
- Whilst old-world (materials) companies we spoke to spent a lot of time talking about their respective positions on the cost curve and how they would work to drive efficiency even harder, the new world e-commerce plays talked to the investments they were making ahead of the opportunity curve to sustain, if not propel their growth trajectories.
- Regarding infrastructure led demand, there are a number of announced projects that will only break ground in the Chinese New year. Rail was mentioned several times throughout the week as was the "One Belt, One Road" concept, however anti-corruption measures appear to have stymied the approval process somewhat.
- Top-tier city property markets remain reasonably tight but continue to be weak in lower tier cities where 6-12 months inventory is common.
- Wage inflation of 5-10% remains a feature of the Chinese economy in all industries (except for heavy materials). Also worth noting, and of cultural significance, was more than one meeting recipient commenting on the relative ease of finding technical employees (engineers, scientists, IT technicians) relative to those with sales/marketing skill bases.

"China cannot rely on extensive development and strong stimulus to achieve targets, otherwise the country will repeat the old path, and then create new contradictions and problems," Xi Jinping, President of China, 02/01/2016



In what is a clever marketing campaign, this Qingdao apartment building is in hot demand in part due to the enquiry phone number.

Enrollment for 2016-17

enquiry@dms.edu.hk

BIG LOSERS

Sector	Sales value change, year-on-year (%)
Jewelry, watches & clocks, and valuable gifts	-22.9
Apparel	-12.3
Motor vehicles and parts	-8.8
Electrical goods and photographic equipment	-7.7

The tightening of capital flows has hurt Hong Kong high end retail, as evidenced by the statistics in this newspaper we saw.

Europe

- U.K economic growth is stronger than the continent, although Spain has bounced back somewhat.
- Corporate balance sheets are generally seen as robust. The industry leading firms acknowledge M&A is to be expected.
- German corporates are cautious following the VW emissions scandal and clearly weaker demand from China for manufacturing exports.
- FMCG contacts we spoke to are observing stable conditions in terms of volume and price.
- Corporates highlighted a weak Euro has been important to their sentiment.
- Emission levels remain topical to corporates. Actions that limit emissions growth are generally embedded in corporate strategies.

Outlook

The market ended a relatively flat year with a solid bounce in December and one of the most anticipated initial increases in US cash rates in history from historical lows. Domestically, the consumer confidence bounce post the change in Prime Minister assisted Christmas turnover for retailers, with the exception of Dick Smith.

At Greencape we continue to observe very patchy macroeconomic demand both by sector and geographically. A recent research trip to China resulted in continued caution in our views as the transition from fixed asset investment towards service sectors continues slowly, yet lending appears overexposed to past fixed asset investment, all whilst China's productivity growth is plateauing and capital outflow pressure remains; not an ideal combination. Our European trips continue to observe amazingly flat conditions that have at least been planned for by corporates, hence an underlying stability is observed to persist. Our US travels continue to highlight patchy conditions, with most economic indicators heading in the right direction, but only just. In an US election year with heightened geopolitical risks and record indebtedness on all levels of government, the US consumer appears slightly more vulnerable today than 3 months ago.

The question of 'what happens if the recovery stalls?' is observed to be a concern at the front of mind in markets today. This concern is something to be monitored closely as it is a driver of behaviour, for both consumers and corporates, and hence a key driver of markets. We expect market volatility will increase as this concern ebbs and flows.

Greencape portfolios remain focussed on bottom up stories and continue to be based on a combination of quality management teams and business franchises. It's worth repeating that despite cheap money, balance sheets are considered an important differentiator when assessing relative valuation. This is only amplified given we continue to observe too many companies favouring short term dividend payments over maintaining strong balance sheets and/or value accretive reinvestment. We begin the year with a cautious approach, a quality bias and are happy to hold higher than usual cash weights so we can take advantage of market volatility.

"Investors objectivity and rationality rarely prevail as much as investment theory assumes, and emotion and 'human nature' often take over instead." Howard Marks, Chairman of Oaktree Capital, 22/10/2015

"Financial markets are manic and best thought of as an erratic counterparty with whom to transact, rather than as an arbiter of the accuracy of one's investment judgments." – Seth Klarman, Baupost Group, Feb 2009

More information

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