Greencape Wholesale High Conviction Fund

Quarterly report - June 2017

Performance #	Quarter %	1 year %	3 years % p.a.	5 years % p.a.	10 years % p.a.	Inception % p.a.
Fund return	0.84	14.96	7.57	12.86	6.04	9.17
Growth return	-2.90	8.13	-0.56	5.04	0.44	2.83
Distribution return	3.75	6.83	8.13	7.82	5.61	6.34
S&P/ASX 200 Accumulation Index	-1.58	14.09	6.63	11.81	3.61	5.77
Active return^	2.42	0.87	0.95	1.05	2.44	3.41

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'.

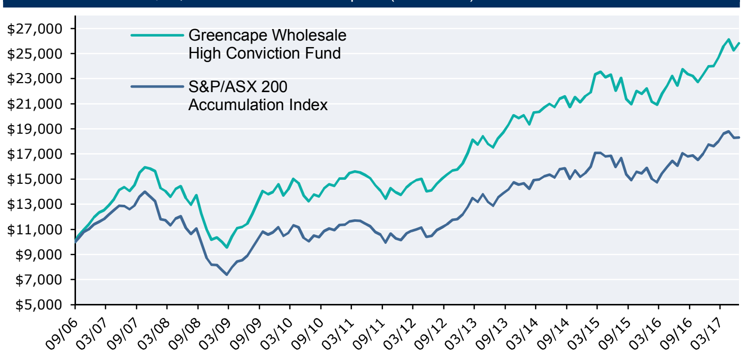
Distribution frequency

Quarterly

Suggested minimum investment timeframe

At least five years

Growth of $10,000 invested since inception (net of fees)

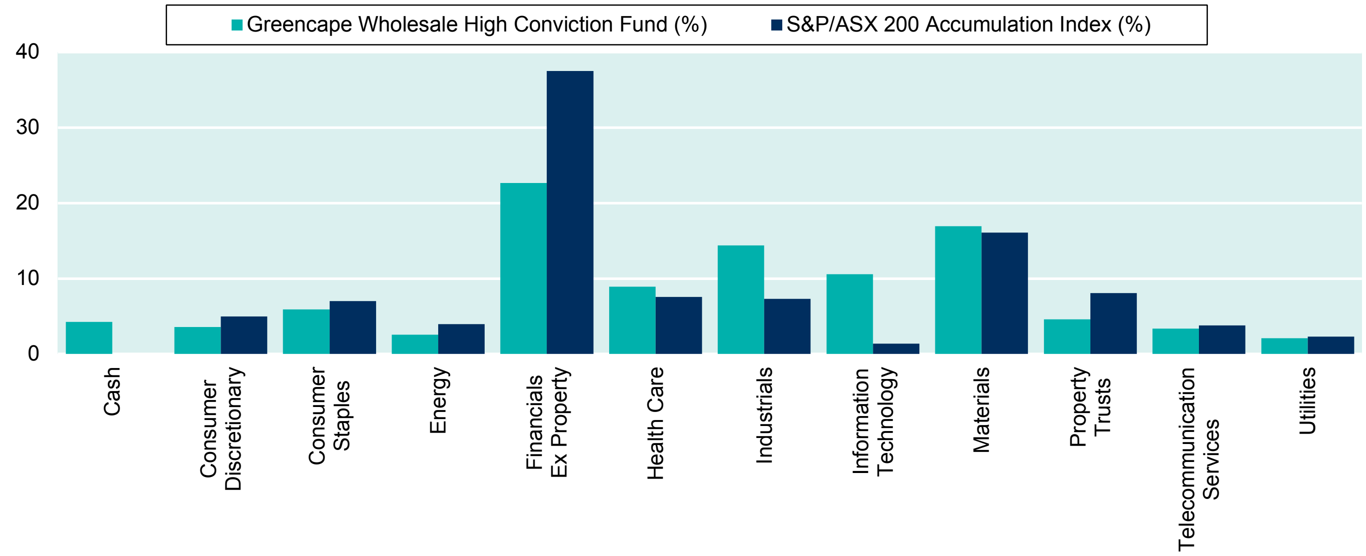


Asset allocation	Actual %	Range %
Security	95.75	85-100
Cash	4.25	0-15

Fund facts	
Inception date	11 September 2006
APIR code	HOW0035AU

Fees	
Entry fee	Nil
2015-2016 ICR	0.91%
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 30 June 2017



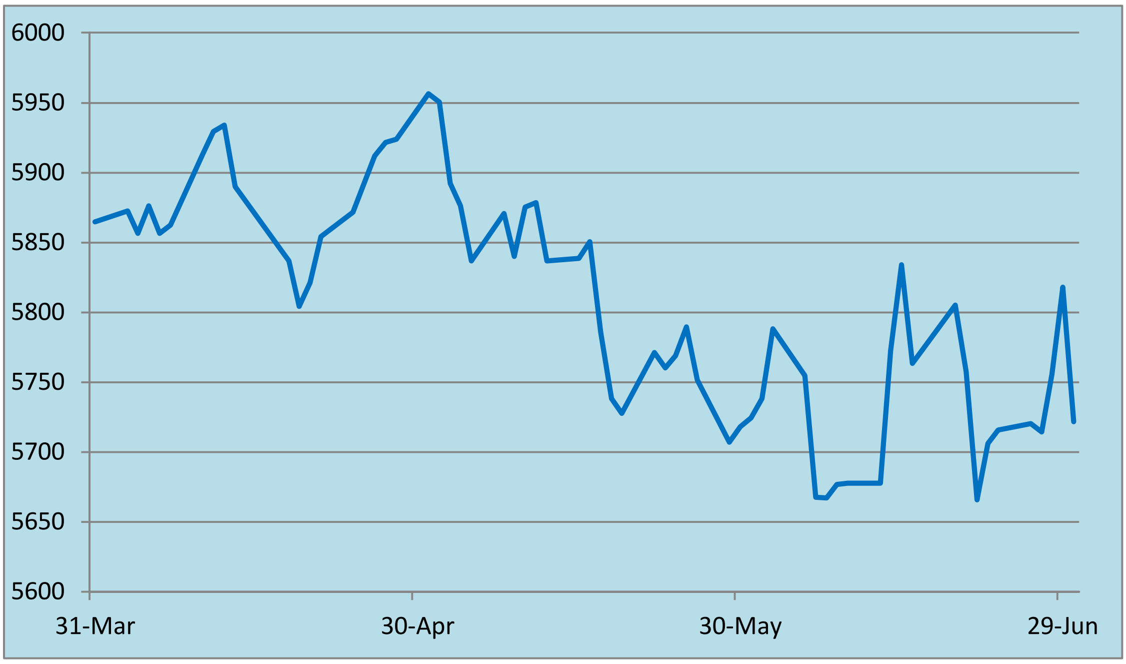
Fund performance summary

The S&P/ASX 200 Accumulation Index returned -1.58% for the quarter. The fund outperformed the market and delivered a +0.84% return over the quarter.

Market overview

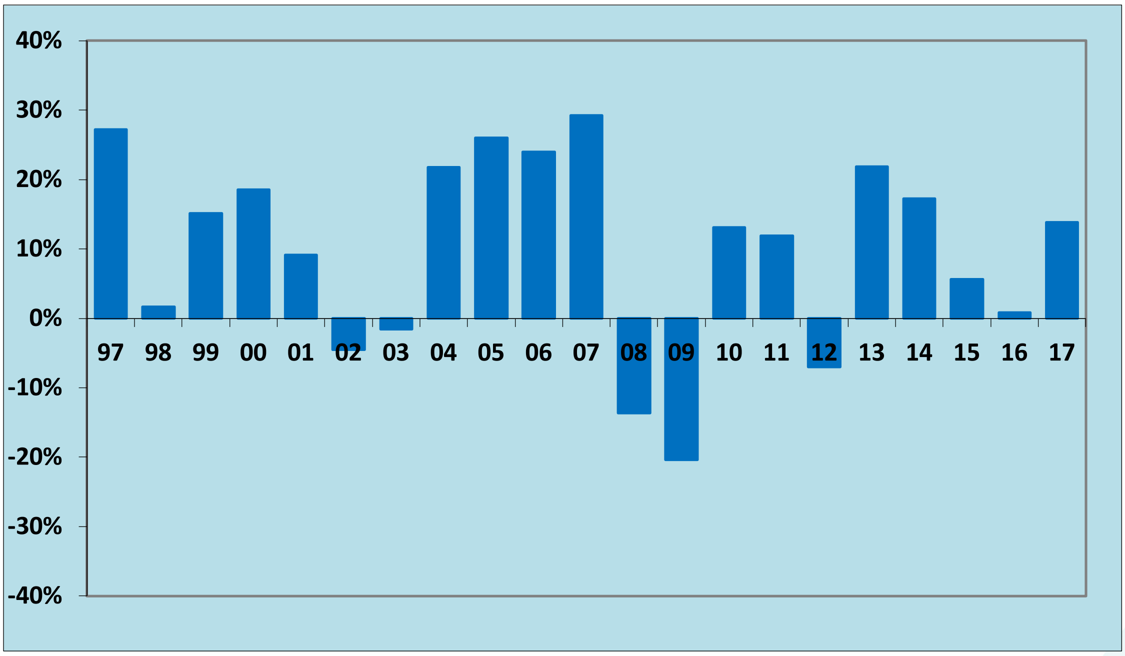
After posting four successive quarters of strong gains, the Australian market's performance was relatively subdued during the period as global market volatility hit multi-decade lows, despite geopolitical concerns continuing to linger. Locally, the looming threat of Amazon's local entry combined with a weaker consumer environment saw retail stocks weaker. Shares of the big four banks were also impacted, as investors digested the impact of the bank levy announced in the May budget.

S&P/ASX 200 Index



Despite a 1.7% fall on the last day of the financial year, FY17 delivered a 13.8% return (including dividends).

S&P/ASX 200 Accumulation Index Financial Year Returns Since 1997

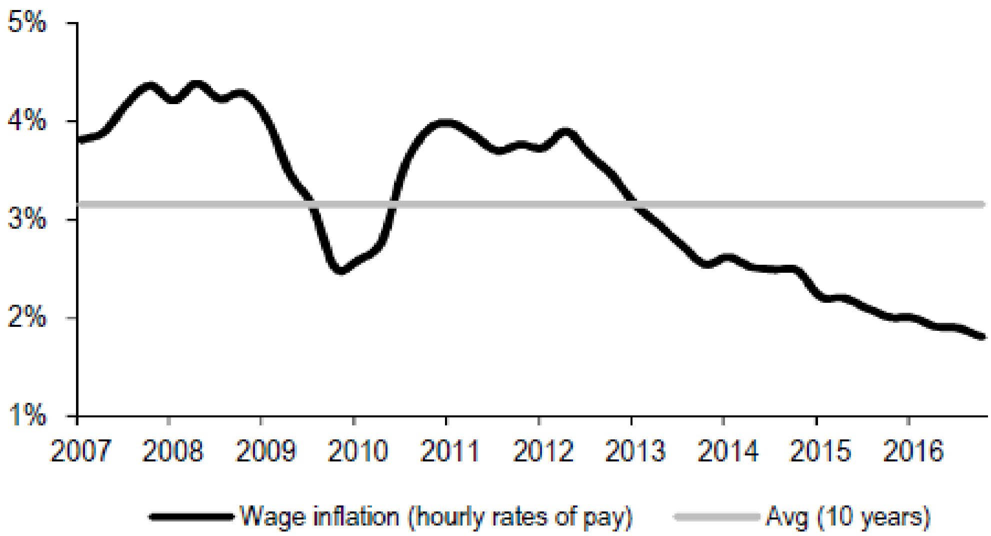


"True Customer Obsession - There are many ways to center a business. You can be competitor focused, you can be product focused, you can be technology focused, you can be business model focused, and there are more. But in my view, obsessive customer focus is by far the most protective of Day 1 vitality." Jeff Bezos, CEO, Amazon, 2016 Letter to Shareholders

As expected the Reserve Bank of Australia kept the cash rate target at the record low of 1.50% at all three meetings during the quarter, the rate at which it has been since August 2016. The futures market expects this to persist, pricing in a less than 30% chance of an interest rate increase within the next 12 months. Economic data during the quarter was mixed, with retail sales growth slowing to its weakest pace in four years, despite unemployment falling from 0.2% to 5.7% (itself a four year low).

As we can see below, wage price growth is languishing as there continues to be excess capacity in the labour market.

Source: JP Morgan



Source: JP Morgan

The major talking point from the May budget was the announcement of a new bank levy, which came as a surprise not just to investors but also to the major banks themselves. The levy, which cleared Parliament in June, will come into effect on 1 July and applies to deposit-taking institutions with licensed entity liabilities of $100bn or more, effectively the big four banks and Macquarie. The banks will have to pay 0.06% of client deposits per year, which is expected to raise $6.2bn over the next four years. The South Australian government also took the unexpected move of announcing a state based tax for the major banks, which itself is projected to raise $97m over the coming fiscal year.

In the US, President Trump finally revealed his administration's much anticipated Tax Plan, a proposal which would cut the corporate tax rate from 35% to 15%. The President continued his habit of tweeting prolifically, however his statements on the social media platform had a more benign impact on financial markets compared to earlier in his term. As expected, in June the Federal Reserve (Fed) raised the target for the federal funds rate by 25 basis points to the range of 1.00% - 1.25%, a move fully priced by the market, akin to the move in March. Whilst the market predicted the previous two rate increases with a high degree of certainty, futures markets are now implying a 50% probability of a further increase this year. The Fed also announced a plan to unwind its balance sheet, allowing maturing bonds to roll off without replacement, up to a cap.

The chart below suggests the US stock market has become detached from economic reality. In June, more than half of institutional investors surveyed still believed that the Trump administration will implement corporate tax reform by year end. There is some risk to equity indexes if implementation is slower than currently anticipated.

Source: Reuters

	June 2017 Quarter	Year ended June 2017
ASX200 Accumulation Index	-1.6%	14.1%
Best performing sectors		
Industrials	8.9%	13.7%
Healthcare	7.2%	15.4%
Information Technology	4.6%	16.9%
Worst performing sectors		
Telecommunications	-8.3%	-21.7%
Energy	-5.7%	8.0%
Consumer Staples	-5.6%	15.7%

For the quarter, Industrials was the strongest performing sector, with the performance being broad based. Qantas was the biggest mover (+ 47%) with a strong domestic trading update in May. Healthcare performed strongly with Fisher & Paykel Healthcare + 26% following a strong reported result in May, whilst Cochclear and CSL were up 17% and 13% respectively for the quarter. In June, CSL announced it would acquire a majority stake in a Chinese plasma fractionator for USD$352m, providing the company with a strategic presence in that market. Information Technology also performed well with all but 2 stocks (MYOB and Aconex) finishing up for the quarter.

"it's the unscripted Trump that's real: a man who barks out bile in 140 characters, who wastes his precious days as president at war with the West institutions like the judiciary, independent agencies and the free press…. Donald Trump's a man that craves power because it burnishes his celebrity. To be constantly talking and talked about is all that really matters and there is no value placed on the meaning of words, so what's said one day can be discarded the next." Chris Uhlmann, journalist, 09/07/17.

Telecommunications was worst performing sector with Vocus falling 27% in the day following their trading update in May, before recovering off its lows to finish down 18% for the quarter after announcing they had received a non-binding takeover approach from KKR. Energy stocks were down almost across the board with the oil price falling 9% during the quarter. Consumer staples showed mixed performance with the infant formula producers, A2 and Bellamy's, up 43% and 75% respectively, whilst Wesfarmers (down 9%) and Coca-Cola Amatil (down 12%) where the large drags on the sector's overall return.

Below was our view from the plane of the shale fields as we flew over Texas in one of our research trips in June.

"In terms of shale, if you had to turn the clock back, and if you knew what we knew today, you wouldn't do it... The timing was way off" Jac Nasser, outgoing BHP Chairman, commenting the ~ $20 billion in capital invested in US shale oil/gas. 29/06/17

Mineral Resources (MIN)

MIN is a stock we've followed since soon after they listed in 2006. MIN's core business has been building and operating mineral crushing plants, the Build, Own and Operate (BOO) model. Management have been in the industry a long time, own large equity stakes personally, and have consistently demonstrated their ability to build and operate crushing plants cheaper and quicker than their competitors, and indeed their own client base who also operate their own plants. This is demonstrated by their list of clients which include BHP, Rio Tinto and Roy Hill.

MIN's core BOO model delivers a reliable income stream to MIN via charging their clients an amount per tonne of ore crushed. Whilst contract lengths vary, the necessity of a crushing plant to a mining operation usually means that MIN's work at each mine site is effectively for the life of the resource, providing MIN a stable income stream.

MIN's experienced and entrepreneurial management team extended their business into opportunistically acquiring otherwise stranded resources and using their in-house crushing and mining services expertise to bring these resources to market. Similarly to crushing, MIN can sell these resources more cheaply than most given their capital cost advantage in building crushing plants. With their in-house team, flat organisational structure and focused management MIN have also demonstrated how quickly they can execute and deliver on projects. To date the focus has largely been on iron ore, where MIN's income is subject to the volatile iron ore price, something that was a strong benefit to them in FY17, but looks like it will be a challenge in FY18 given the recent fall in the iron ore price, particularly for low grade material.

Potentially offsetting the decline in iron ore earnings for MIN in FY18 is lithium. MIN own stakes in two WA lithium assets, Mt Marion which is 43% owned, and Wodgina which they own 100% of. Mt Marion produces a spodumene concentrate which first shipped in February 2017 and is expected to ramp up to 400,000 tonnes over the subsequent 12 months, at which point it will produce approximately 50kt of LCE[1] , making it the second largest hard rock mine globally.

[1] Lithium Carbonate Equivalent

Wodgina was acquired by MIN in June 2016 for an undisclosed sum. It was until recently a tantalum and iron ore mine which MIN owned and operated the crushing plant for, hence MIN understood the asset well. After purchasing the asset MIN has been drilling for Pegmatite (the lithium containing mineral) with the size of the resource currently standing at 121 million tonnes[2], making it a sizeable prospective mine. Whilst MIN are considering building a spodumene processing plant, similar to the approach at Mt Marion, in the meantime MIN has already begun shipping raw pegmatite ore (DSO[3]) to China, where Chinese buyers will process the ore that would normally take place at the mine site. Whilst this has the disadvantage of trucking and shipping a large amount of waste ore, the end lithium spot prices are sufficiently high for this to be economically attractive for MIN, at least for the time being. We estimate MIN earned approximately $20m in June alone from DSO, but it's worth noting the future earnings remain uncertain. The DSO market is untested and requires unknown Chinese counterparties to be able to effectively recover the lithium from a low grade ore which is technically complex, and if successful it will rank as relatively high cost supply vs the traditional hard rock and brine sources. But if nothing else, DSO gives a clear indication of MIN's ability to find and exploit an asset in a very short period of time for what looks like a very high return on capital. Deutsche Bank estimate MIN will earn a greater than a 200% Internal rate of return on (IRR) on Wodgina.

In addition to the stable crushing revenue stream and the iron ore and lithium operations touched on above, MIN continues to work on finding new market niches to exploit, and which we think have the potential to add significant value to shareholders in the future. An example of this is the development of carbon fibre truck trays which MIN are currently testing and which could allow large mining trucks to carry approximately 10% more per load given the weight reduction versus steel. If successful this could help the mining industry more broadly to significantly reduce mining costs.

So overall, whilst we're cognisant of MIN's exposure to end market commodity prices (mainly iron ore and lithium today) which we have little faith in our own ability to forecast, we think MIN's stable crushing earnings are under-appreciated by the market. Combined with MIN's clean balance sheet, attractive valuation relative to the share price, and management's track record in finding and creating value for shareholders, MIN is a stock that looks attractive to us which we currently own.

Outlook

We observe market volatility has just begun to increase recently. We also observe that globally, macro-economic conditions remain patchy yet directionally consistent, suggesting that low economic growth going forward is sustained. Indeed, central banks outside of Australia have become a touch more hawkish despite subdued wages growth and inflation. Locally our feedback from numerous company contacts is that activity has picked up since Easter, despite out of cycle rate hikes by banks targeting property investors. As I write we are largely through profit warning season.

Looking ahead, reporting season looms. The sustainability of recent demand momentum will be critical as companies frame their own outlook commentary. We observe a large number of companies have market earnings expectations which implies accelerated growth in FY18. With sentiment influencing geopolitical risk rising, and the past year of earnings multiple expansion driven returns, which were solid (ASX200 AI +14.1%!), we consider some caution is warranted. We cannot stress enough the value of trusted and effective management teams and shareholder stewardship. We expect such attributes will come to the fore in the coming quarters. We also consider balance sheet and liquidity are factors currently under-appreciated by markets.

"For the last nine years, central banks drove interest rates to nil and pumped money into the system creating favorable carries and abundant cash. These actions pushed up asset prices, drove nominal interest rates below nominal growth rates, pushed real interest rates on cash negative, and drove real bond yields down to near zero percent, which created beautiful deleveragings, brought about balance sheet repairs, and led to more conventional economic conditions in which credit growth and economic growth are growing in relatively good balance with debt growth. That era is ending." Ray Dalio, Bridgewater, 06/07/17.

[2] 120.8MT Indicated and Inferred at 1.28% Li20 as at 28/04/17
[3] Direct Shipping Ore (DSO)

More information

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

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