Greencape High Conviction Fund

Quarterly report - September 2017

Performance #	Quarter %	1 year %	3 years % p.a.	5 years % p.a.	10 years % p.a.	Inception % p.a.
Fund return	3.27	14.78	8.75	11.66	5.54	9.28
Growth return	2.23	8.13	0.51	3.91	-0.06	2.97
Distribution return	1.05	6.65	8.24	7.76	5.60	6.31
S&P/ASX 200 Accumulation Index	0.68	9.25	7.09	10.09	3.09	5.70
Active return^	2.59	5.53	1.66	1.57	2.45	3.58

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'.

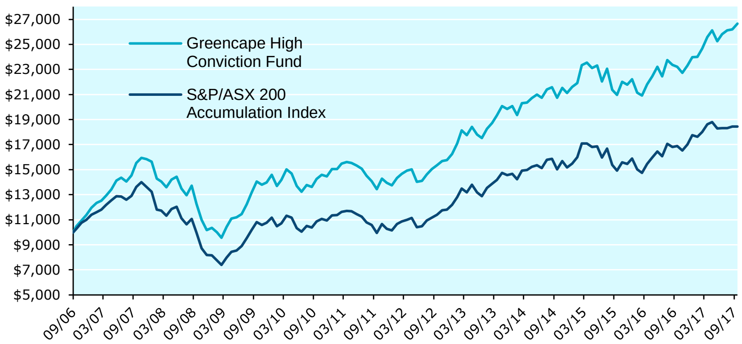
Distribution frequency

Quarterly

Suggested minimum investment timeframe

At least five years

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

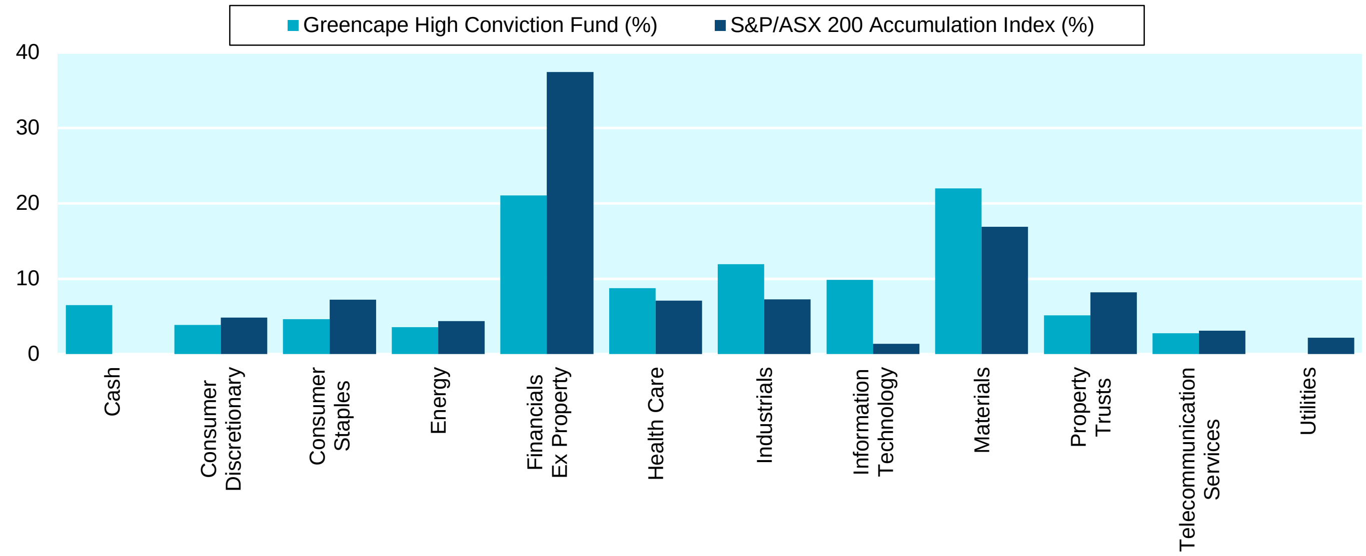


Asset allocation	Actual %	Range %
Security	93.51	85-100
Cash	6.49	0-15

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 September 2017



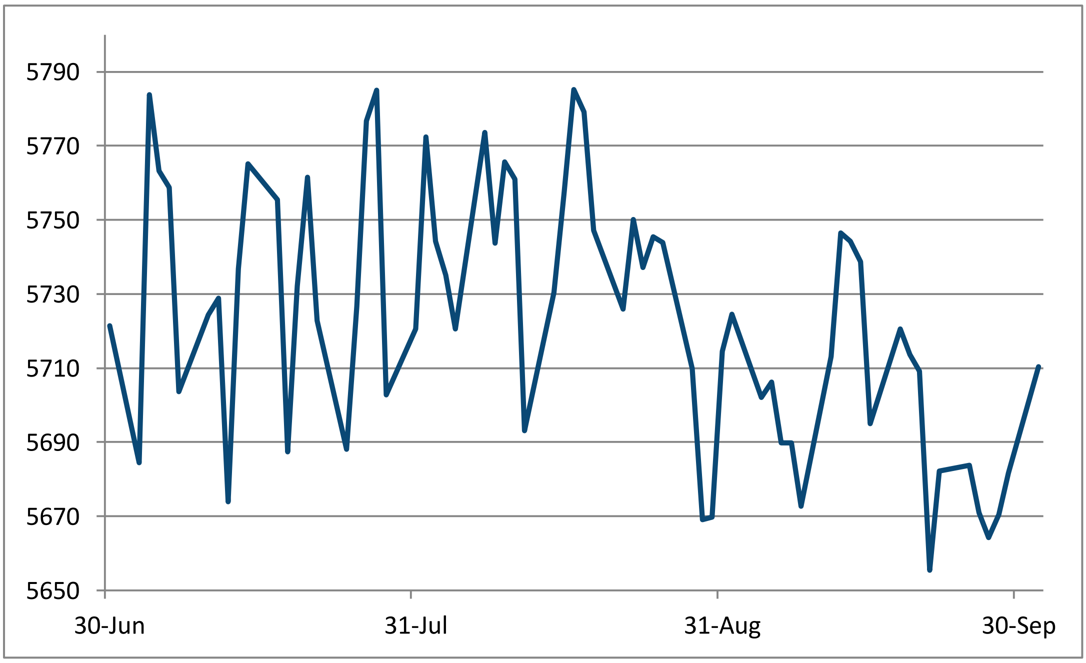
Fund performance summary

The S&P/ASX 200 Accumulation Index returned +0.68% for the quarter. The fund outperformed the market and delivered a +3.27% return over the quarter.

Market overview

Global markets were subdued during the September quarter, as volatility remained at all-time lows. Geopolitical tensions however continued to simmer in the background, with investors keeping a watching brief over North Korea and the US President's Twitter feed. The Trump administration again failed to repeal and replace Obamacare, but investors still remain hopeful that some form of tax reform will be passed. Locally, attention was focused on the August results season.

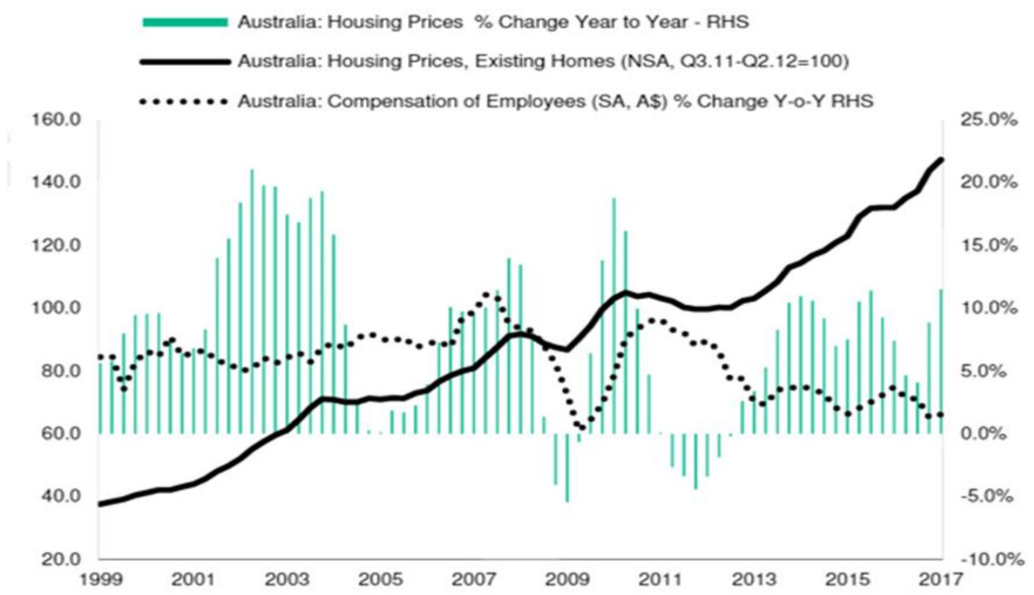
S&P/ASX 200 Index



As expected, the Reserve Bank of Australia left rates on hold for all three meetings during the quarter. The futures market probabilities now imply that no hike is expected until July 2018. The big four banks continued to attract publicity as it was revealed the CBA failed to report thousands of suspicious transactions to AUSTRAC. The bank faces a potential maximum penalty of $966 billion if it was fined for all of its 53,700 breaches individually. Late in the period, the big four banks attempted to regain some goodwill in the public eye by abolishing ATM fees.

"I think it's quite possible... that the RBA could indeed want to get to a 3.5 per cent cash rate by the end of 2019" Dr John Edwards, former RBA board member, 19/07/2017

House prices in Sydney actually declined in September, the first monthly decline since 2015, albeit only by 0.1%. Despite the dip, house price appreciation domestically has been incredibly strong and out of step with wage growth as shown below.

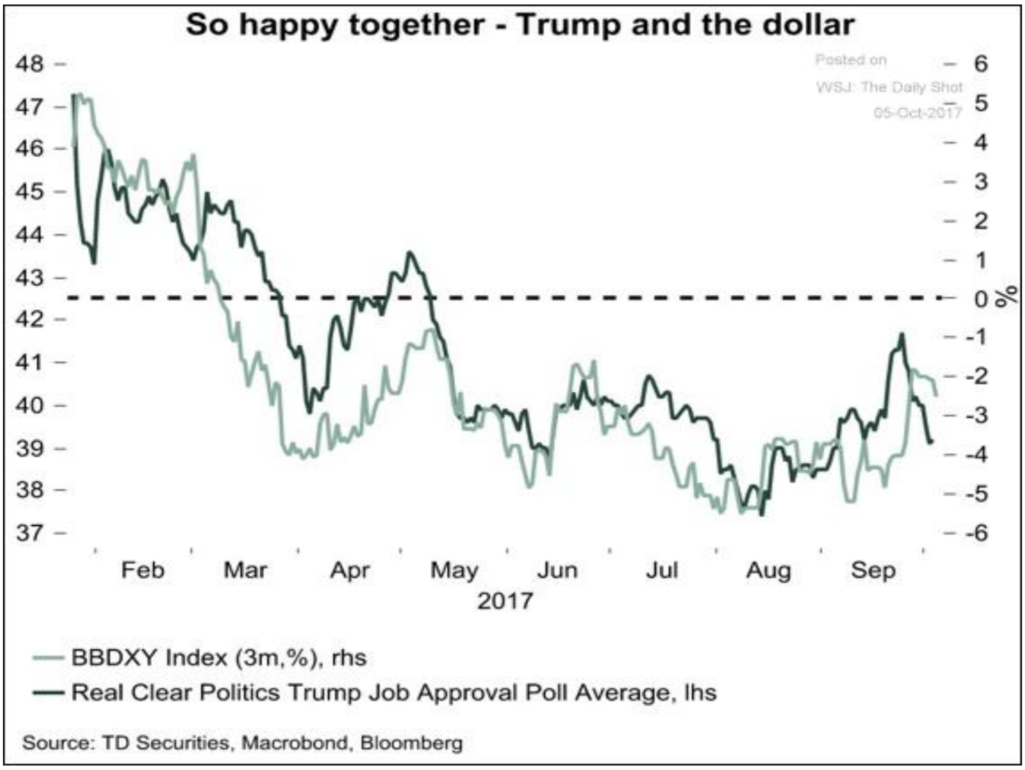


Source: ABS

Tensions between the US and North Korea escalated during the quarter as the two respective leaders traded rhetorical fire. President Trump threatened the secretive state with 'fire and fury like the world have never seen', with Kim Jong Un calling Trump a 'dotard' and 'frightened dog' in response. A number of weather events wreaked havoc on U.S. coast lines during the period, however neither these weather events nor geopolitical tensions managed to dampen market spirits, as the S&P500 index closed at an all-time high at the end of the quarter. Comments by the Federal Open Market Committee in September struck a more hawkish tone than expected, which triggered a rally in the USD and heightened expectations for a rate increase by the end of the year.

"Just heard Foreign Minister of North Korea speak at U.N. If he echoes thoughts of Little Rocket Man, they won't be around much longer!" Donald Trump, President of the United States of America, 24/09/2017

We don't believe this correlation between the President's approval rating and the USD is a coincidence.



News flow was relatively quiet elsewhere around the globe. Economic data out of China continued to print strongly ahead of the 19th National Congress of the Communist Party of China on October 19th, where a major party reshuffle will take place. China gross domestic product grew at 6.9% for the June quarter, 0.1% ahead of expectations. In Europe, European Central Bank President Mario Draghi said the central bank saw 'unquestionable improvement' in Eurozone economic growth, whilst also indicating that possible changes to the Quantitative Easing program will take place in the near future. Despite winning the French presidential election by a landslide in May, President Emmanuel Macron's approval rating fell to 30% in September as he battles to pass unpopular labour reform. Brexit negotiations between the EU and UK entered their 'fourth round' in September, but worryingly the talks have not yet touched on the matter of trade arrangements.

"We are becoming more confident that inflation will eventually head to levels in line with our inflation aim." Mario Draghi, ECB President, 25/09/2017

Locally, market participants were focused on the August reporting season. Stocks with high growth multiples whose result or forward earnings guidance disappointed were again treated viciously by the market, including Domino's Pizza and Healthscope. Large cap discretionary retail names, despite trading on optically cheap multiples continued to weaken on Amazon concerns despite posting results in line with market expectations.

	Sep 2017 Quarter	Year ended Sep 2017
ASX200 Accumulation Index	0.7%	9.2%
Best performing sectors		
Energy	7.3%	12.3%
Materials	6.5%	17.3%
Consumer Staples	4.4%	7.4%
Worst performing sectors		
Telco	-15.4%	-29.1%
Utilities	-5.9%	15.3%
Healthcare	-5.2%	6.5%

A rebound in commodity prices saw Energy and Materials perform well. Crude oil rallied 12% for the quarter, whilst base metals including copper, nickel and aluminium all rallied strongly (aided in part by a weaker USD). Within the Energy sector, Origin announced the sale of its conventional oil and gas business Lattice to Beach Petroleum for $1.59 billion. The lithium producer rally which began in 2016 enjoyed a second wind, with Galaxy Resources, Mineral Resources and Orocobre all rallying strongly.

Telecommunication stocks were the worst performing sector for the third consecutive quarter. The sector which was traditionally considered defensive has now lost nearly a third of its value over the past year. Telstra (which composes the majority of the index) had a tough August, as the company announced a cut in the dividend as well as a rejection of its proposal to monetise a portion of is lock-in recurring NBN receipts.

Lend Lease – Leveraging Their Alan Bond

Lend Lease is a global integrated provider of Construction, Development and Investment services as it relates to scale property.

The company was able to take advantage of a lack of industry capital to secure Barangaroo at an exceptional price (and favourable risk terms) in 2007, and over the past ten years Lend Lease has built a compelling global Urban Regeneration Development business.

Urban regeneration is the process whereby a valuable piece of land, typically adjacent or nearby an existing CBD precinct, is redeveloped into a multi-use facility (Residential, Commercial, Retail and Park Land). This plays particularly well to the global trends of urbanisation, aging population and sustainability. Like all good Alan Bonds, the Barangaroo deal is not one we expect to be replicated any time soon. Lend Lease are however doing an exceptional job, using the Barangaroo precinct as an effective display home to woo Governments and Councils of global gateway cities to win new projects. We estimate that Lend Lease is one of 3 global players large enough to compete in this space. Major projects in Boston, Chicago, Singapore and KL are all but 4 examples of projects either underway or completed. We recently visited the latter two and were impressed with the progress and effective ‘de-risking’ of both projects.

The power of the integrated model is the ability to ‘clip the ticket’ across multiple parts of the supply chain from Design to Construction, Development and ultimately Funds Management. The ability for the Development arm to use internal construction capabilities should prima facie reduce overall delivery risk. The Funds management business provides a willing buyer of Lend Lease product (alongside 3rd party capital) which has the compelling benefit of effectively liberating capital that is then available to invest into the next project. This is a very efficient capital model.

To add a bit of cream upon the cake, Lend Lease is also a significant player in the Australian Infrastructure Construction space. With a compelling list of government sponsored infrastructure projects yet to be awarded in Melbourne and Sydney, we see Lend Lease as well positioned to continue to grow this part of its business in a well-controlled manner.

Remuneration matters! Admirably, management are running with an under geared balance sheet (approximately 5%) despite their long term inventive driving them to do the opposite. That is to say that CEO Steve McCann could achieve the upper end of his return on investment target and maximise his remuneration by gearing the balance sheet. This is not however in the best interests of the shareholders when the Australian property market looks to be at elevated levels. This should be acknowledged and rewarded by way of a rerating.

"We remain focused on operational excellence and this will be implemented via a rigorous approach to risk management, an unwavering commitment to health, safety and sustainability, and a disciplined approach to origination." Steve McCann, CEO of Lend Lease, 27/08/2017

Whilst we won't go into the intricacies of our Lend lease valuation, we will mention that the last time Lend Lease traded at this share price (2.5 years ago), it attracted a price/earnings multiple of 15x vs the 12x it trades on today. It would be remiss of us not to point out that in that period they have reduced gearing, progressed through 2.5 years of apartment settlements, have raised a meaningful provision against future settlements (effectively de-risking them), whilst continuing to grow its Development Pipeline and Construction backlog. Therefore, we think today that the future earnings profile is arguably better than at any time over the past 10 years.

Model of Lend Lease's TRX project in Kuala Lumpur

The TRX project under construction.

Offshore trips

This quarter we travelled to the US and Asia twice, as well as Europe.

Asia Electric Vehicles (EV) observations

- China dominates EV demand today, however demand from Europe and the US is now starting to come through and is expected to pick up significantly in the near future. The next few years will still have a high percentage of Hybrids sold (fraction of the lithium content of a full EV), but as battery costs come down a greater percentage of full EVs will be sold.
- EV producers are able to re-tool existing production lines relatively easily, whilst battery and component manufacturers also have the ability to scale production in the event of a sustained upswing in demand.
- There was a lot of debate of when the ‘tipping point’ will be (when mass car makers decide to stop making petrol cars and embrace EV’s fully). Most people we spoke to expect this to be some time next decade.
- The regulatory environment surrounding EVs is expected to remain positive in the near future as government seek to curb pollution.

US Media & Technology observations

- Beyond the initial corporate shift to the cloud, there are a number of additional themes to play out over the next decade which should see cloud requirements continue to ramp up. For example, electronic gaming is moving towards the cloud which will require higher bandwidth for streaming.
- A Wholefoods fully integrated into Amazon could go in a number of different directions. It can provide private label product for Amazon's online channel and also provide 450 points of collection. Amazon GO (their walk in / walk out / no check out supermarket concept) could potentially be rolled out there also.
- Twitter is being left behind. They are now 'asking' users for their birthday so they can collect more insightful data.
- The average daily user of Snapchat takes over 20 'snaps' per day!

"If you're competitor-focused, you have to wait until there is a competitor doing something. Being customer-focused allows you to be more pioneering." Jeff Bezos, President & CEO, Amazon, 19/11/2008

An Amazon GO store in Seattle – just walk out!

Outlook

We observe the Australian equity market has decoupled somewhat from the previously strong lead from the US market. It is evident the Australian index composition with over 50% from banks and resources companies, plus a large exposure to mature low growth industrials is resulting in underperformance against the US indices. Since the Presidential election in November, the US has enjoyed a record run of positive monthly returns, whilst the Australian market has been more range bound.

Greencape consider the market caution towards banks is warranted. This caution stems from evidence that house price growth is slowing, thus mortgage book growth is also showing signs of moderation. This, coupled with a relatively highly geared consumer makes domestic consumption very sensitive to interest rates and further availability of credit. It came as no surprise to us that July and August retail sales were so weak and we expect more of the same with the run into Christmas. That said we don't expect too much bad news from the banks in their reporting season that is in a few weeks' time.

"Slow growth in real wages and high levels of household debt are likely to constrain growth in household spending." Philip Low, Governor of the RBA, 02/10/2017

Greencape believes we are in the mature stage of the post global financial crisis bull market. With a combination of low economic growth and low inflation, mature industries are not getting any free kicks and there are few macro tailwinds for sales and earnings growth. Overlay the low cost of debt, and many weak business models being disrupted by technology, we observe the climate for a step up in mergers and acquisitions activity is upon us. With increased mergers and acquisitions activity, we expect much value will be created and destroyed. We reiterate that we consider effective management teams that can allocate capital wisely are undervalued, as the environment has rarely been better for such teams to execute and add shareholder value.

"Our EBITDA can be whatever we want next year…we're choosing to invest aggressively… our opportunities are greater than ever". Andrew Bassett, CEO Seek, 16/08/17

More information

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

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