Greencape Wholesale High Conviction Fund

Quarterly report - March 2017

Performance #	Quarter %	1 year %	3 years % p.a.	5 years % p.a.	10 years % p.a.	Inception % p.a.
Fund return	6.77	17.30	7.92	11.37	7.06	9.31
Growth return	6.27	12.12	-1.14	4.36	0.81	3.18
Distribution return	0.50	5.19	9.06	7.02	6.25	6.13
S&P/ASX 200 Accumulation Index	4.82	20.49	7.53	11.09	4.32	6.06
Active return^	1.95	-3.19	0.40	0.28	2.73	3.25

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

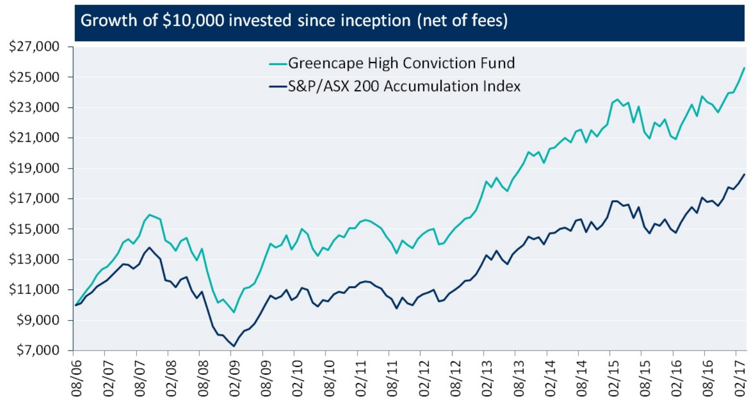
Greencape is an active, 'bottom-up' stock picker. Whilst Greencape does not target any specific investment style and will invest in stocks displaying 'value' and 'growth' characteristics, its focus on a company's qualitative attributes will generally lead to 'growth' oriented portfolios. This is an outcome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

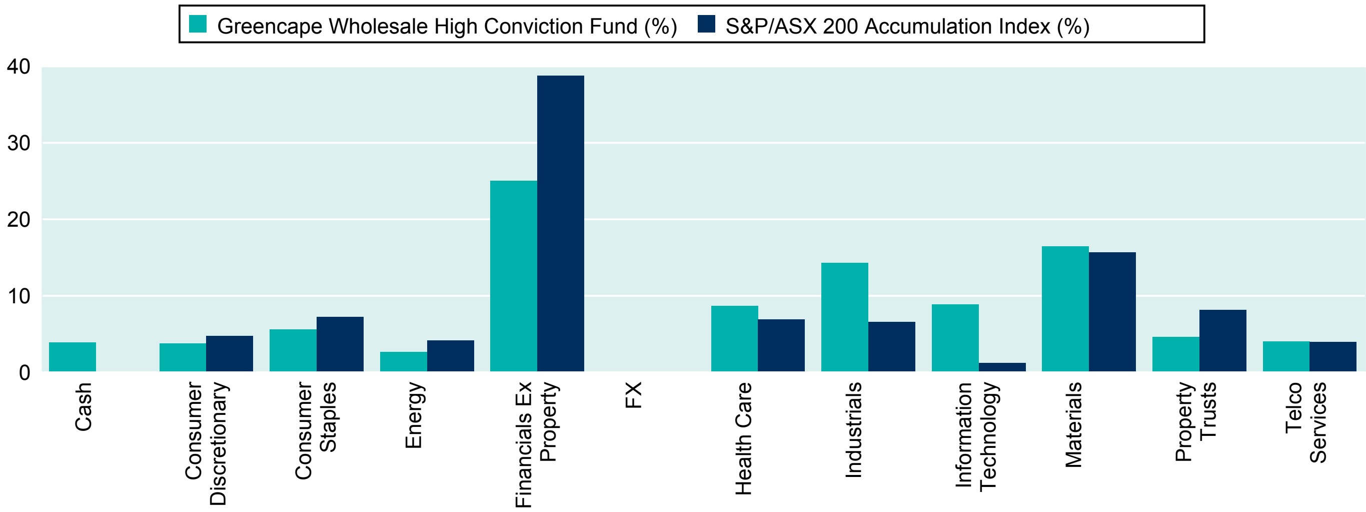


Asset allocation	As at 31 March 2017 (%)	Range (%)
Security	96.14	85-100
Cash	3.86	0-15

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 31 March 2017



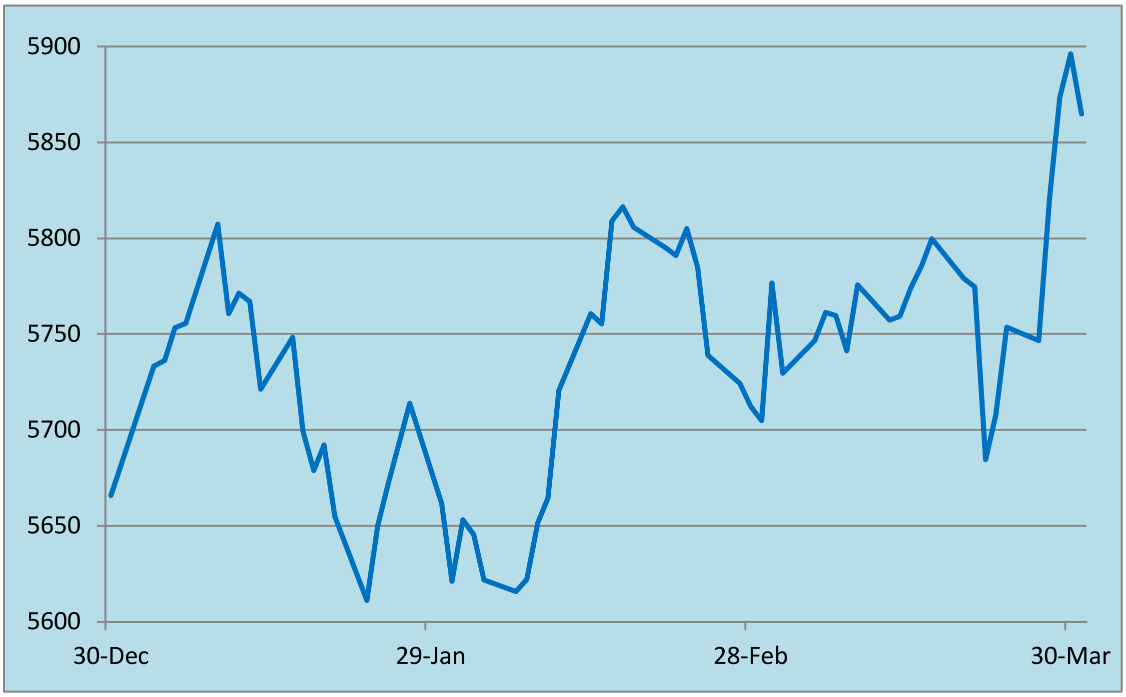
Fund performance summary

The S&P/ASX 200 Accumulation Index returned +4.82% for the quarter. The fund outperformed the market and delivered a +6.77% return over the quarter.

Market overview

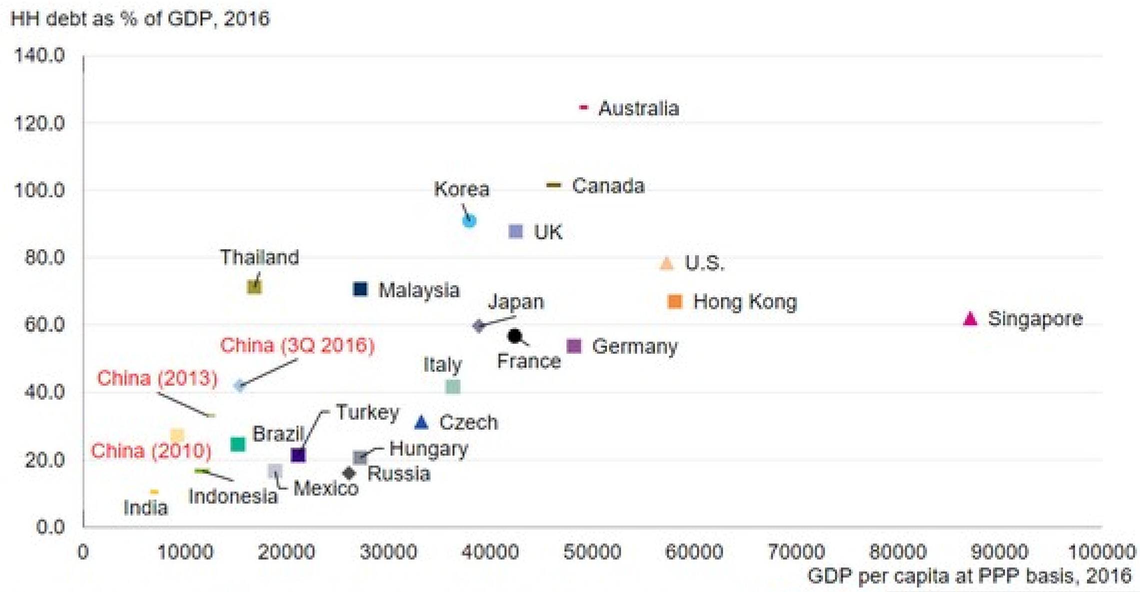
The markets kept their focus on the Trump administration during the period, with global indexes posting strong gains in the hope the former reality TV star would "Make America Great Again". Locally, investor attention was focused on the February reporting season which this year was preceded in January with a number of unexpected earnings guidance updates. The housing market also continued to attract headlines, with new measures being introduced in an attempt to slow the remarkable growth in prices.

S&P/ASX 200 Index



As expected, the Reserve Bank of Australia (RBA) left rates unchanged during both meetings held during the period. The futures market now implies around a circa 85% probability of the RBA holding rates at the record low level of 1.5% until at least May 2018. Similar to what occurred late last year, the banks took it upon themselves to raise variable mortgage rates independent of any action from the RBA. The rate hikes weren't uniform over all mortgage products however, with the banks opting to raise rates on investor loans (particularly interest-only investor loans) more than the on owner-occupier loans. In late March, the Australian Prudential Regulation Authority (APRA) announced a 30% limit of interest-only loans for new lending, and also asked banks to place strict internal limits on the volume of interest-only lending at loan-to-value ratios (LVRs) above 80 per cent. As we see below, Australia's household debt to GDP is elevated compared to the rest of developed world, especially so when measured on a GDP per capita basis.

"Too many loans are still made where the borrower has the skinniest of income buffers after interest payment." Philip Low, Governor of the RBA, 04/04/2017



Note: Headline debt figures for public, non-financial corporate and household sectors are based on BIS total credit statistics.

Sources: Moody's Investors Service and IIF

President Trump was inaugurated as the 45th President of the USA on the 20th of January. He wasted no time implementing his isolationist agenda, withdrawing from the Trans Pacific Partnership and signing an executive order restricting immigration from select Muslim countries. Investors continued to invest in the 'Trump Reflation' theme, with US equity indexes reaching fresh all-time highs in March.

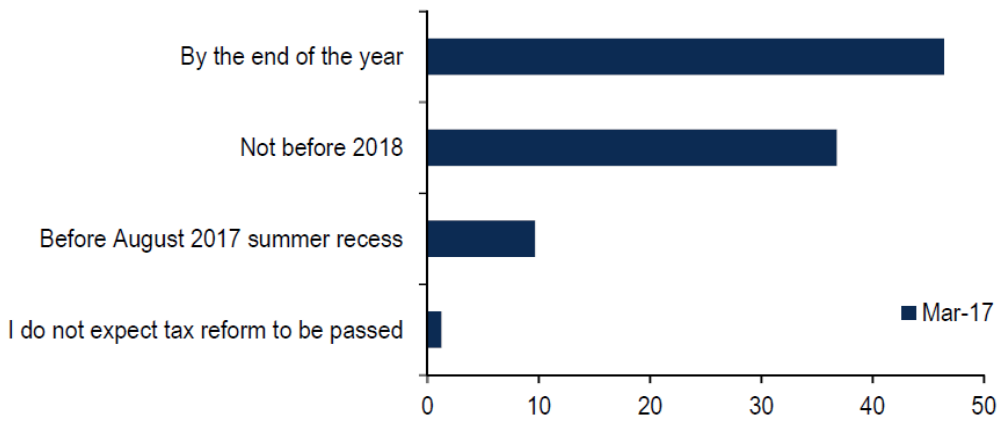
Trump's first major test to implement one of his key election policies, to 'repeal and replace' Obamacare, did not succeed as the President failed to garner sufficient votes from a Congress controlled by his own party. Whilst the Healthcare reform itself was of minor relevance for the market, it made investors question whether Trump could implement his major business friendly tax reforms as promised. This moment of doubt saw equity indexes register a minor blip, which was erased almost immediately after the President announced he would now focus his effort on "big tax cuts and tax reform". In March, the US Federal Reserve raised the target range for the federal funds rate from 0.75% to 1%, a move fully priced in by markets.

A Global Fund Manager survey recently conducted by Merrill Lynch showed that over half of the institutional investors surveyed expected tax reform to be passed by the end of 2017. Any delay to reform implementation may hurt market sentiment.

"Lowering the overall tax burden on American business is big league ... that's coming along very well." Donald Trump, President of the USA, 09/02/2017

"The House has a (tax reform) plan but the Senate doesn't quite have one yet. They're working on one. The White House hasn't nailed it down… So even the three entities aren't on the same page yet on tax reform" Paul Ryan, Speaker of the United States House of Representatives, 05/04/2017

How soon do you expect tax reform to be passed in the US?

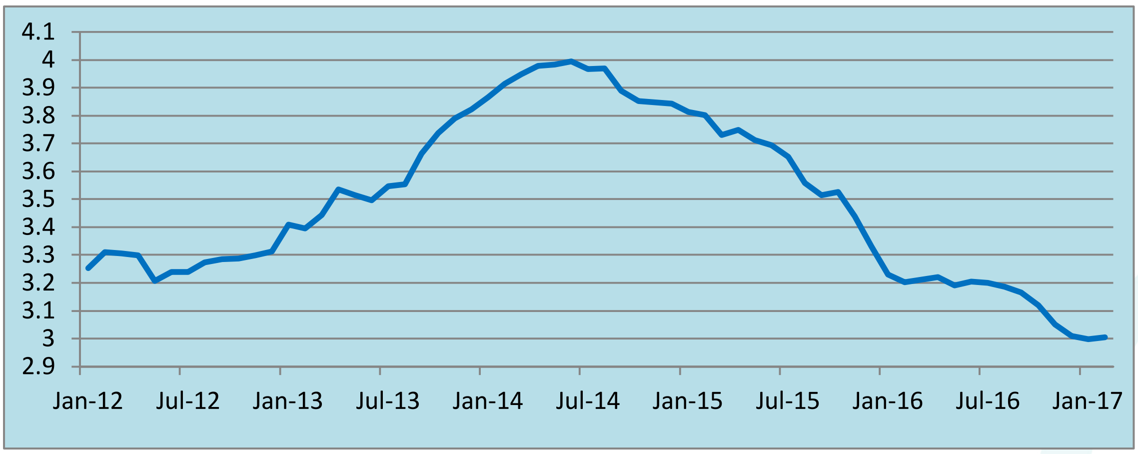


Source: Merrill Lynch

Elsewhere, British Prime Minister Teresa May formally invoked Article 50, the first step in the UK exiting the European Union. Markets continue to monitor developments in the French election closely, with the Euro currency reacting to far-right candidate Marine Le Pen's progress in the polls. Whilst she remains a distant chance to win the Presidency, markets are understandably tepid given similar poll results for Brexit and the Trump presidency, which both came to fruition. In China, GDP for Q4 2016 came in at 6.8% annualised, beating market expectations of a 6.7% gain. Retail sales for February disappointed however at 9.5% growth, against expectations of 10.5%.

Since peaking at over US$4 trillion dollars in 2014, China's FX reserves rebounded back above the psychologically important $3 trillion level in March.

China FX Reserves (USD trillion)



Source: Bloomberg

The market transition out of high growth and high multiple stocks into banks and resources which we observed in Q4 last year only partly reversed, with Healthcare (typically a high valuation sector) being the best performing sector during the period. This was aided by a full year earnings upgrade from CSL, which announced in January that due to better than expected sales performance in immunoglobulins and speciality products, that the company expects net profit after tax growth of 18-20%, instead of the previously guided 11% growth.

	March 2017 Quarter	Year ended March 2017
ASX200 Accumulation Index	4.8%	20.5%
Best performing sectors		
Healthcare	14.9%	18.8%
Consumer Staples	10.8%	18.1%
Utilities	10.7%	28.4%
Worst performing sectors		
Telecommunications	-4.6%	-11.1%
Property Trusts	-0.3%	6.0%
Materials	1.8%	39.0%

There were a number of earnings downgrades in January before the February reporting season. Organic infant formula company Bellamy's issued its second earnings downgrade in two months, citing lower than expected demand and excess inventory. Brambles, a supply-chain logistics company, also downgraded its guidance before reporting season due to revenue and cost pressures in its North American pallets business due to US retailer destocking.

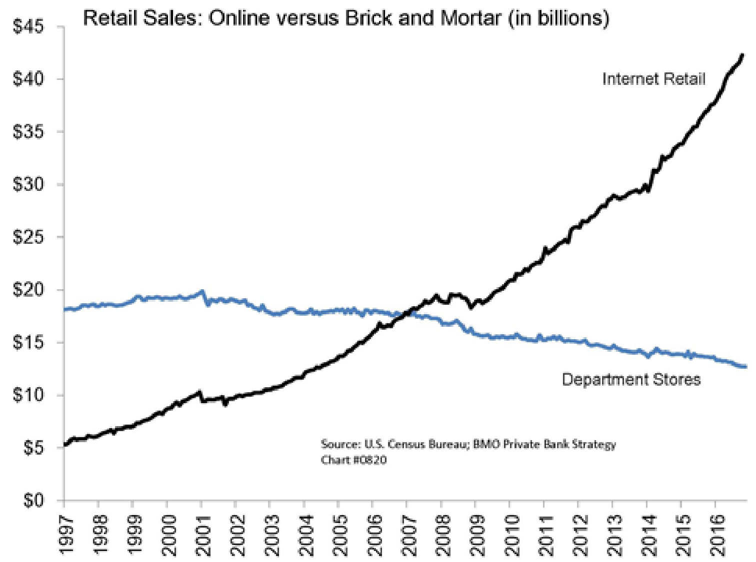
There was some corporate activity late in the period, with Downer EDI launching a takeover bid for Spotless at $1.15 cash per share, a 59% premium to Spotless' last price before the announcement. Premier Investments also revealed itself as the mystery buyer of an 11% stake in department store retailer Myer. The company stated it did not currently intend to make a takeover offer for Myer.

Amazon

Much has been speculated recently about what a potential Amazon entry could mean for incumbent brick and mortar retailers in Australia. Despite Amazon not yet formally announcing their intention to bring their proven marketplace model physically to our shores, we think the jungle drums are beating sufficiently loud enough to believe their arrival is a matter of when, not if. We cannot with a high degree of certainty predict what exactly will occur to the retail ecosystem in Australia when Amazon arrives, however we have observed some interesting trends offshore in markets where Amazon has already reached a critical mass.

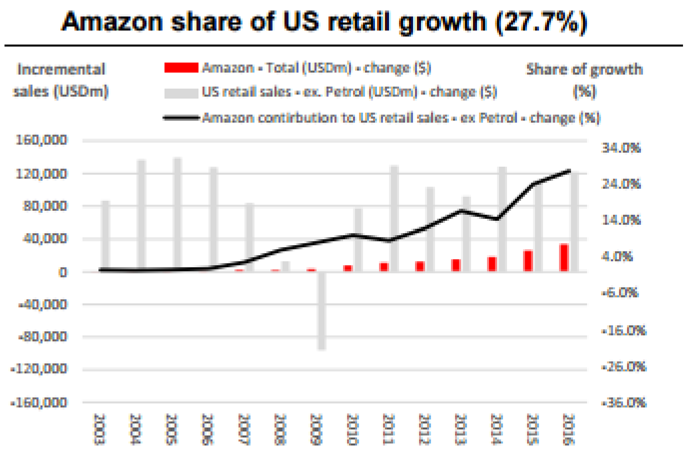
The effect on the status quo in the US retail (Amazon's home market) has been staggering. The U.S. Census Bureau estimates that U.S Department store revenues in 2016 were $7.2bn lower than in 2001, a 36% decline. On the contrary, online sales have been growing at a remarkable rate.

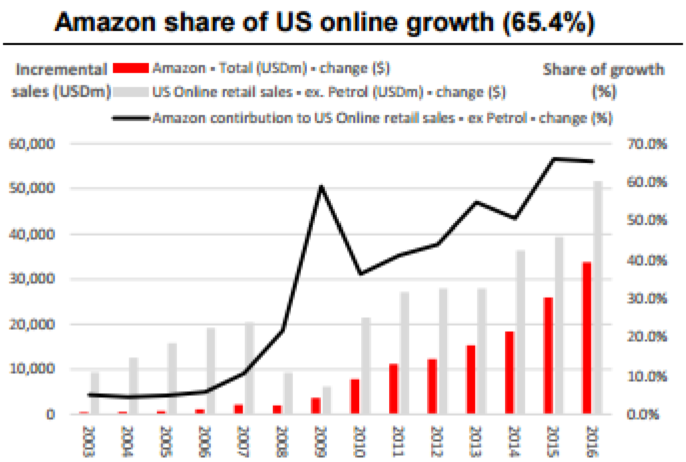
"If your biggest market, or biggest developed market in the world is at 20% (corporate tax rate), how can we sit at 30%?" Malcolm Turnbull, Prime Minster of Australia, 05/04/2017



Source: CNBC

In the US, Amazon's share of total retail growth was 28% in 2016, while their share of online sales growth was 65%. This doesn't leave a lot of sales growth left for existing retailers to grow their comparable sales, a key driver of share price performance.

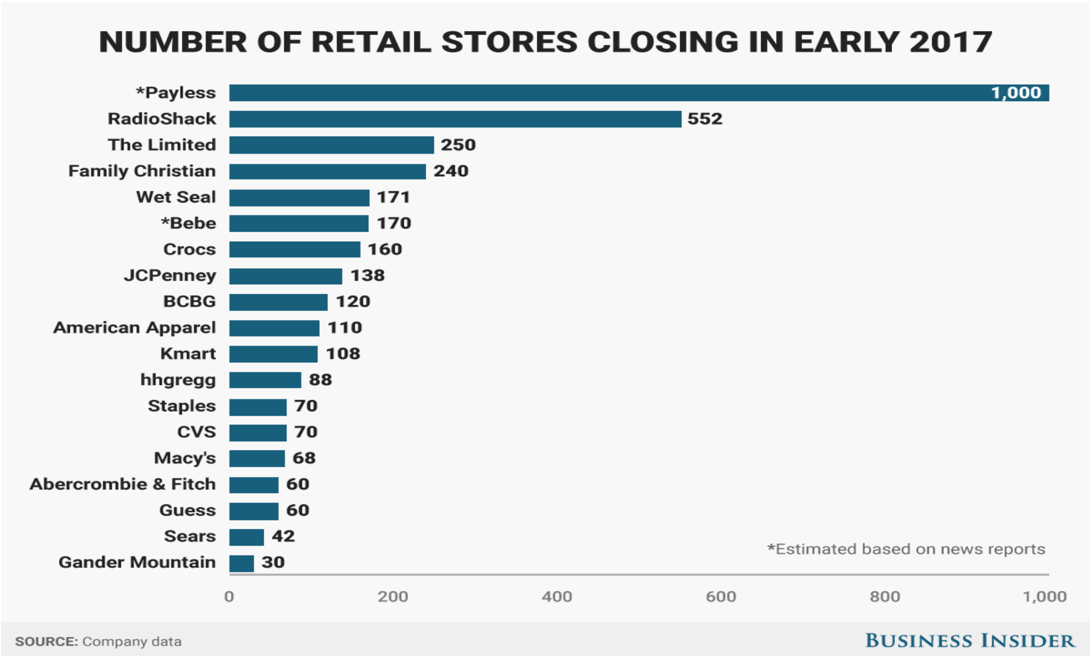




Source: Macquarie

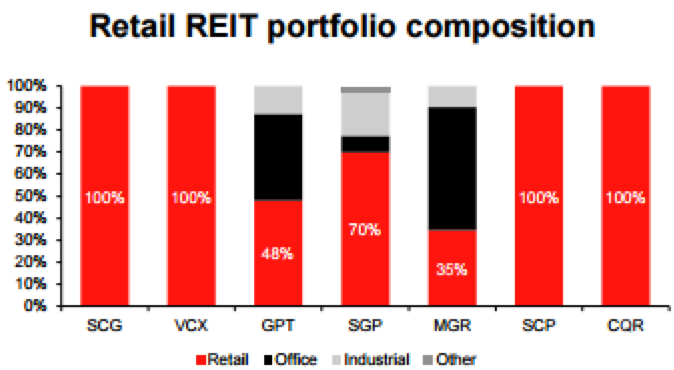
"Your margin is my opportunity." Jeff Bezos, Chairman, founder and CEO of Amazon

This seismic structural shift in the market has caused significant disruption in the US retail market, with declining sales forcing a number of traditional bricks & mortar retailers to scale back their physical presence.



Source: Business Insider

Store closures announced during the most recent US reporting season included large department store chains such as Macy's, JC Penney and Sears. Many of their stores are considered 'anchor tenants' in a mall, whereby their enlarged presence would drive traffic into a shopping centre, benefitting the smaller specialty retailers. The exodus of an anchor tenant means the owner of the mall needs to find a replacement, which in the current environment is a near impossible task. Hence the current structural shift in the retail landscape has also impacted Real Estate Investment Trusts (REIT's) with retail exposure through ownership of shopping malls. We can see in the following chart which Australian listed REITS are potentially vulnerable to disruption by a successful Amazon entry.



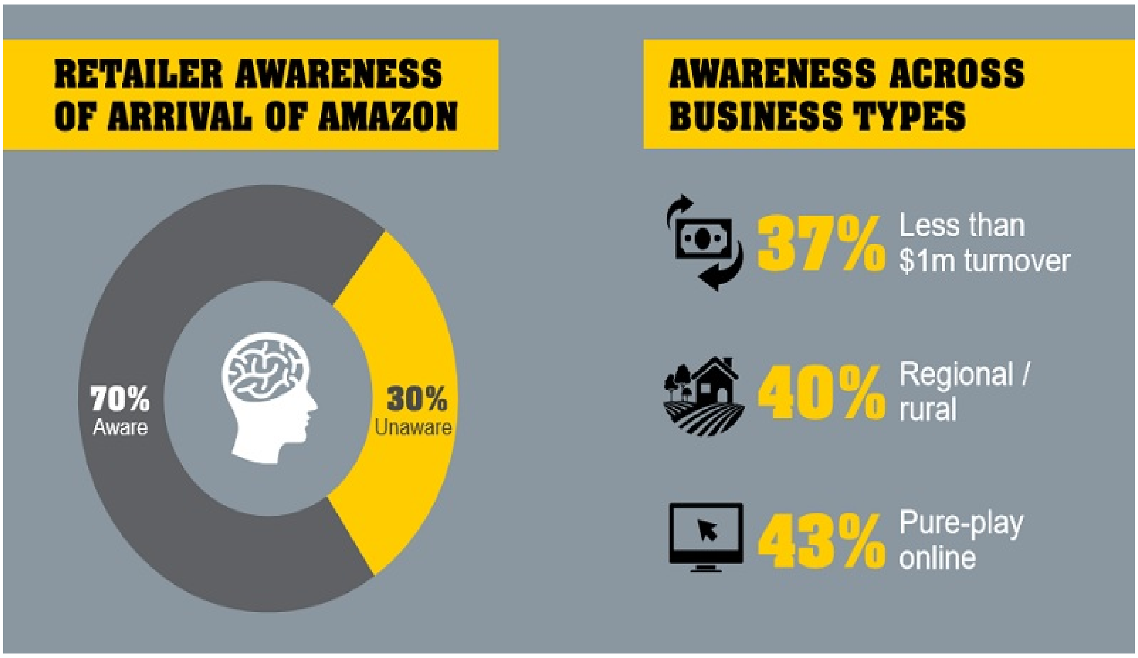
Source: Macquarie

To successfully defend share market share against Amazon, an incumbent retailer needs a lean cost structure in order to compete on price with Amazon's marketplace where hundreds of sellers could be vying to sell the same item. The proliferation of mobile apps makes competing on price vital, as customers often compare the price on an item online while they are in store. A large retailer also needs a quality omnichannel offering, whereby the store effectively leverages their physical presence with a customer friendly e-commerce platform.

"Retailing is a tough business… In part, this is because a retailer must stay smart, day after day. Your competitor is always copying and then topping whatever you do. Shoppers are meanwhile beckoned in every conceivable way to try a stream of new merchants. In retailing, to coast is to fail." Warren Buffett, Chairman of Berkshire Hathaway

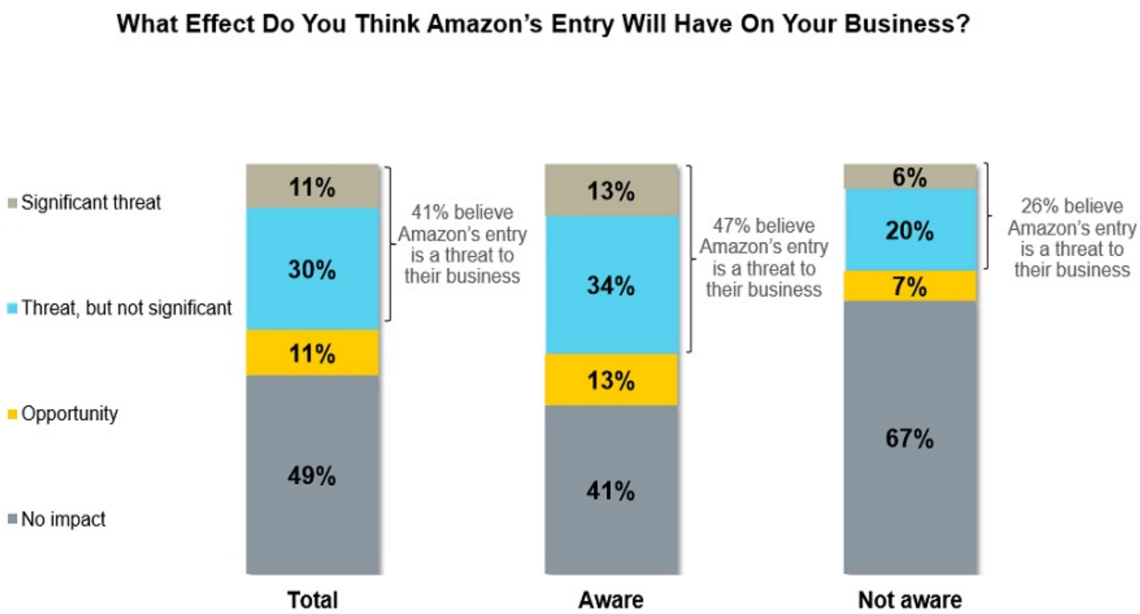
"I think when you consider the commentary around Amazon, the retailers who are most vulnerable are retailers who don't own their own brands or are in commodity categories." Mark McInnes, CEO of Premier Investments, 21/03/2017

Worryingly, according to a survey undertaken by CBA many Australian retailers do not seem to be aware of Amazon's impending entry.



Source: CBA

While only a small percentage see it as a significant threat.



Source: CBA

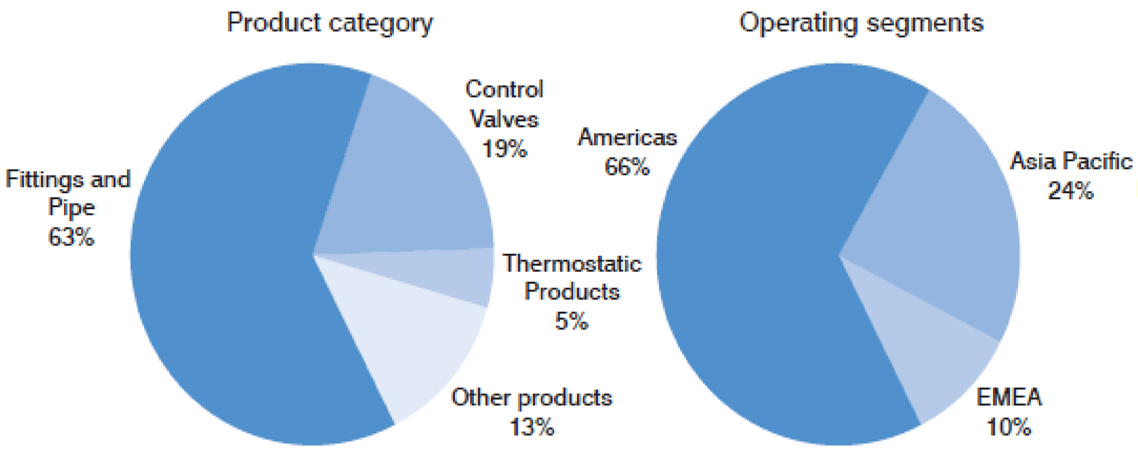
Whilst this complacency is dangerous and may be the undoing of some retailers, we expect the majority of large retailers to have some form of plan for Amazon's entry. Currently, online retail platforms in Australia have much to be desired with most being clunky and difficult to use, thereby creating a poor customer experience. In order for incumbent retailers to compete with the vastly capitalised and superior technology of Amazon, they will need to dramatically improve their e-commerce platforms to mitigate the risk of being disrupted out of business.

Reliance Worldwide

In April 2016 we participated in the Initial Public Offering (IPO) of Reliance Worldwide Corporation (RWC) at an issue price of $2.50 per share. RWC is a global leader in the manufacture of fittings, pipes, valves and other products for behind-the-wall plumbing applications and hot water systems. RWC manufactures over 14,000 products for residential and commercial applications, with a principal focus on the residential repair and renovation end-market. Approximately two thirds of RWC's sales are from the Americas (predominantly the US), 24% from Australia and New Zealand, and 10% from Europe (predominantly the UK). RWC manufactures across 11 sites globally with the majority of products manufactured in Australia today, but with a substantial portion of the growth in manufacturing to be delivered from their US facilities.

Approximately two thirds of RWC's revenue is derived from selling fittings and pipe under its premium Sharkbite brand. Over the past decade, Sharkbite's disruptive brass push-to-connect (PTC) fittings have taken an approximate 10% market share in the residential fittings market in the US, primarily due to its key properties of being faster and easier to install compared to traditional fittings. RWC dominates the brass PTC market with a greater than 80% market share and commands a substantial price premium versus its competitors. Over time we expect ongoing market share penetration of brass PTC fittings and product expansions under the Sharkbite brand to underwrite strong long-term growth for RWC. We consider product development and innovation to be a key differentiator of RWC vs. its competitors.

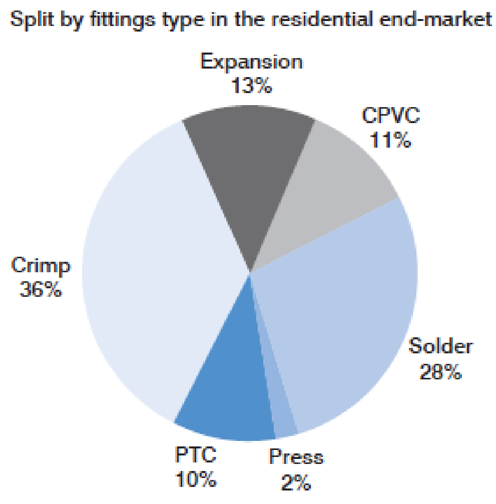
2015 financial year net sales composition



Source: Reliance Worldwide

"We had the market to ourselves for two years and we did a lot of really good work from a sales marketing and branding point of view to establish ourselves in the marketplace." Heath Sharp, CEO of Reliance Worldwide, 22/04/2016

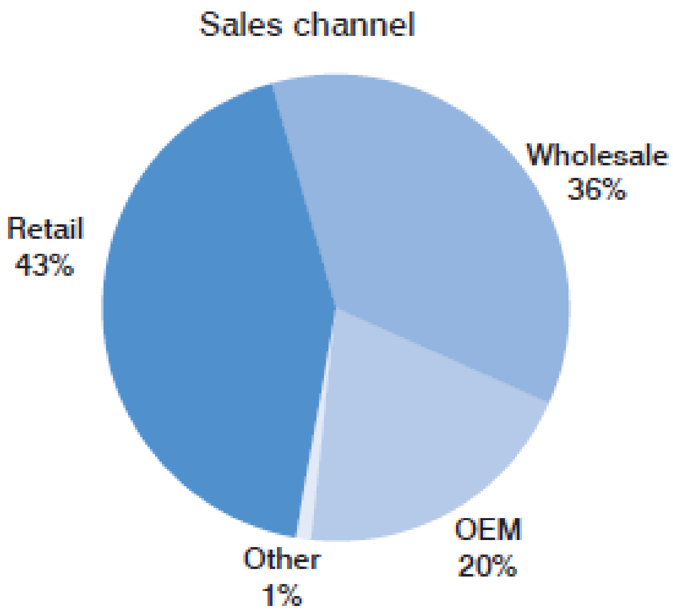
2014 US fittings market shares for residential end-market



Source: RWC IPO Prospectus

RWC supplies its products in the US through a variety of sales channels, including Wholesale, Retail and Original Equipment Manufacturers (OEMs). At IPO, RWC sold its products in the US Retail channel exclusively through The Home Depot (THD), the largest hardware retailer in the US with over 2000 stores. In August 2016, RWC announced that it had ended its exclusive agreement with THD and had contracted to supply its full range of Sharkbite products to Lowe's, the second largest hardware retailer in the US with over 1700 stores. Despite in the same month delivering a maiden profit result that exceeded their Prospectus forecasts, RWC stock was sold off from a high of $3.40 to under $3.00 on market concerns about the change in retail distribution so soon after the IPO. RWC viewed the opportunity to substantially expand its footprint and market opportunity for its Sharkbite range of products with Lowe's as offering greater upside than any potential loss in business through THD on extinguishment of the exclusive agreement. We agreed and used the share price weakness to increase our shareholding below $3.00.

2015 financial year net sales composition



Source: Reliance Worldwide

Brass PTC Fitting with Sharkbite logo

Source: Reliance Worldwide

In February 2017, RWC again delivered a profit result ahead of Prospectus forecasts, had reduced is leverage from 1.6x Net Debt to Earnings Before Interest, Taxes, Depreciation and Amortisation at IPO to 0.9x and announced that THD would continue to sell the majority of Sharkbite's products in the majority of their US stores, which in our view is a favourable outcome relative to market expectations. We have continued to increase our holding in RWC below the $3.00 level as we see the current forward Price to Earnings Ratio of 21x to be reasonable given the quality of the business, its track-record of strong growth delivery and the long-term growth runway ahead. Today the stock trades at the same earnings multiple as it did at listing, yet we believe that the business is better positioned today with the change in the retail distribution noted above.

Offshore Trips

This quarter we travelled to the US three times, Europe twice, China and New Zealand.

China observations

- 2017 will be 'stable'. Every contact we spoke to mentioned the word 'stable' at least once to describe this year. There is a major leadership transition at the '19th National Congress of the Communist Party of China' in autumn (October or November), and there is an expectation things will run smoothly into the event.

- At the congress in autumn, economic reform is expected to be high on the agenda but the shape of the reform is uncertain.

- Inventory levels across most commodities are now back at normal levels with the 2016 restock cycle having now played out. Iron ore inventories are high, however so is steel production.

- The production response to higher prices has been disciplined due to supply side reform. There is stricter monitoring, enforcement and adherence than previous iterations of such reform.

"Self-isolation will never lead one to the land of happiness… A trade war will not make trade fairer. Protectionism offers no genuine protection." Li Keqiang, Premier of the State Council of the People's Republic of China, 22/03/2017

US observations

- Sentiment has improved since the election with at least a partial unleashing of the animal spirits. As the year progresses so does the pressure on the administration to implement its policy agenda. The second half of the calendar year will be an interesting test for the current levels of optimism.

- The health and wellness trend in the US continues to build in prominence with the US's largest natural products expo this year attracting a record of more than 80,000 attendees and over 3,100 exhibitors. At the expo A2 Milk launched its new chocolate milk product for the US market, which the company is hoping to leverage off an emerging trend in the US for chocolate milk as a post workout supplement, due to its favourable combination of carbs and protein for muscle recovery (apparently…).

- Amazon is coming. Their strategy of bundling a Prime Video streaming account (similar offer to Netflix) with free two day shipping on all Amazon online purchases will be a very compelling offer in Australia. Across certain products and geographies in the US Amazon is already offering two hour shipping, and we've heard separately they're ultimately targeting 30 minutes (which is less time than it would take you to go to the store and come back).

- On a weekend in Washington DC, the number of people in the streets protesting in favour of Trump far outweighed the number of people protesting against him – don't let 'fake news' reporting from the 'failing' New York Times distort the picture about who the average man/woman on the street in DC is supporting!

Outlook

Despite cautious commentary domestically regarding housing bubbles, federal budget issues, a challenging senate plus some weak data such as retail sales and employment, our market continues to take its lead largely from the US. The US continues to deliver constructive economic data and the Trump administration promises of large scale tax reform, particularly 'huge' corporate tax cuts are driving bullish market sentiment.

At Greencape we have been surprised at the strength of the market, and the broad nature of the move. We expect US tax cut speculation has a risk of disappointing, insofar that implementation may take longer than expected. We also believe the market is not factoring in offsetting policies such as the Border Adjustment Tax which will be needed to fund the tax reform.

Given the market's strong run, a number of our key stocks have seen us take profits and subsequently our cash weights have risen to higher than typical levels. We are both cautious and comfortable with our higher cash balance, and we are exercising patience in deploying it. We consider management skill and a stock's liquidity are undervalued by the market at present. These characteristics are considered increasingly attractive in our stock selection.

"The inescapable fact is that the value of an asset, whatever its character, cannot over the long term grow faster than its earnings do." Warren Buffet, Chairman of Berkshire Hathaway

More information

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

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