Greencape Capital

Greencape Wholesale High Conviction Fund

Quarterly report - June 2015

Performance #	Quarter %	1 year %	3 years % p.a.	5 years % p.a.	7 years % p.a.	Inception % p.a.
Fund return	-6.47	6.28	16.07	10.71	7.25	9.39
Growth return	-16.52	-6.82	6.61	3.88	1.59	2.85
Distribution return	10.05	13.09	9.45	6.83	5.66	6.54
S&P/ASX 200 Accumulation Index	-6.55	5.68	15.06	9.69	5.29	5.46
Active return^	0.08	0.60	1.00	1.02	1.96	3.93

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

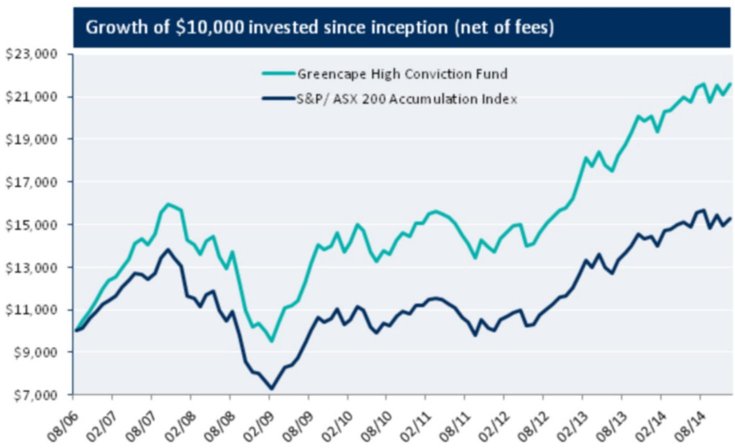
Greencape is an active, 'bottom-up' stock picker. Whilst Greencape does not target any specific investment style and will invest in stocks displaying 'value' and 'growth' characteristics, its focus on a company's qualitative attributes will generally lead to 'growth' oriented portfolios. This is an outcome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

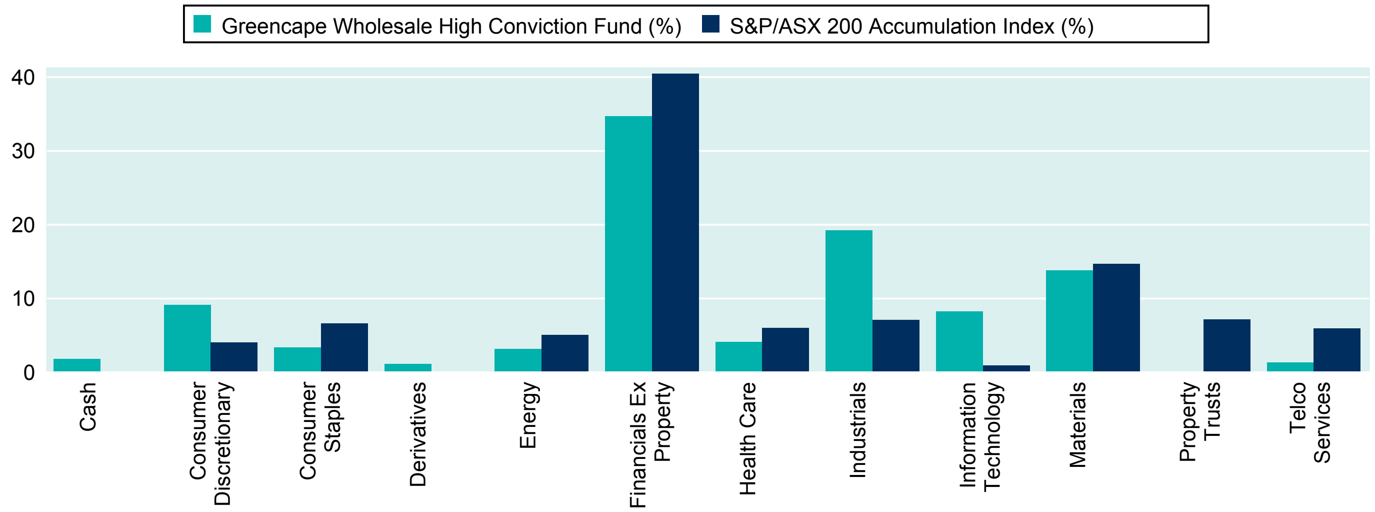


Asset allocation	As at 30 June 2015 (%)	Range (%)
Security	98.19	85-100
Cash	1.81	0-15

Fund facts	
Inception date	11 September 2006
APIR code	HOW0035AU

Fees	
Entry fee	Nil
2013-2014 ICR	1.16%
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 2015



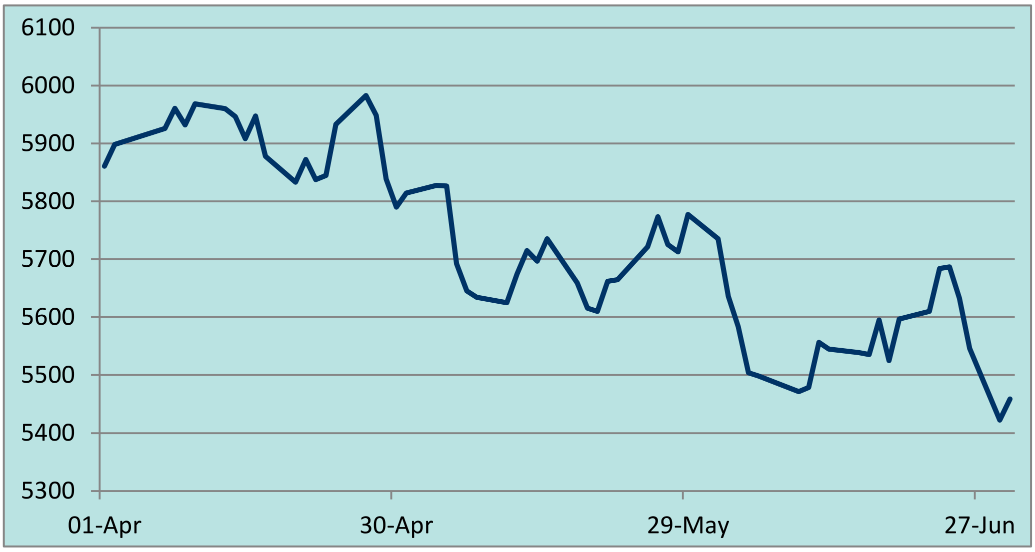
Fund performance summary

The S&P/ASX 200 Accumulation Index returned -6.55% for the quarter. The fund outperformed the market and delivered a -6.47% return over the quarter.

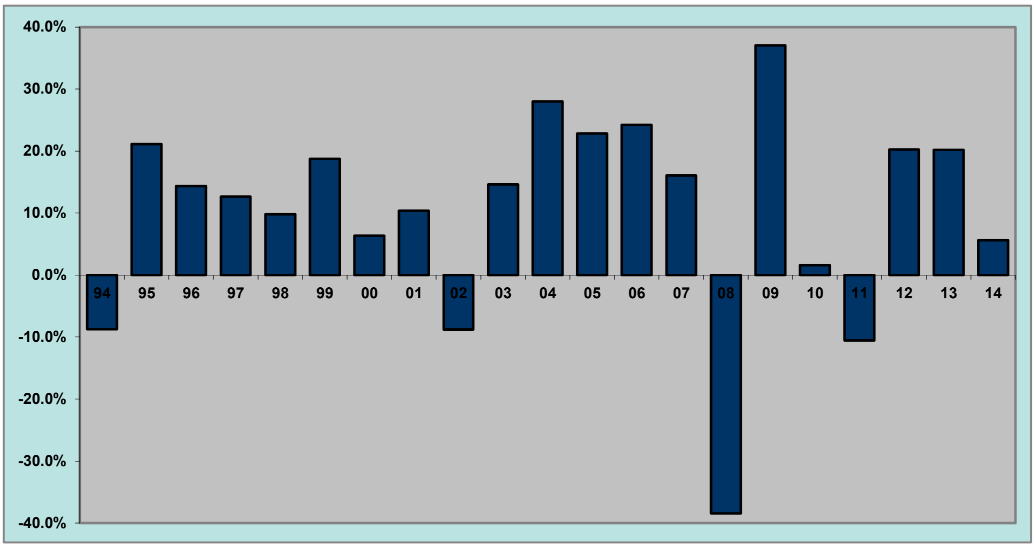
Market overview

After a strong start to the calendar year, the market followed up with three consecutive negative months this quarter, posting its worst quarterly performance since September 2011. Macroeconomic concerns took hold, with the uncertainty of rising US interest rates, the Chinese share market's meteoritic rise then fall and Greece's looming debt repayment deadline driving the local market's direction.

S&P/ASX 200 Accumulation Index



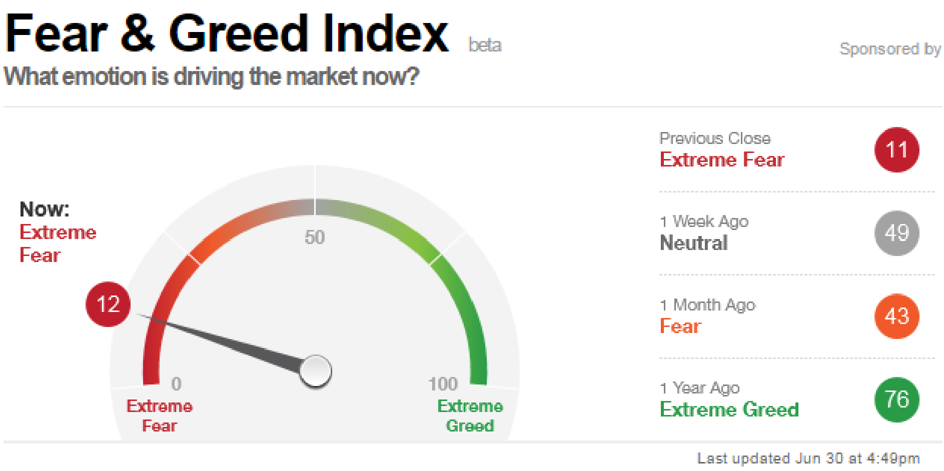
S&P/ASX 200 Accumulation Index Financial Year Returns Since 1994



In May, the RBA cut rates for the second time in four months, taking the overnight cash rate to a new record low of 2.0%. The Federal Government released its second budget since coming to power, this one being significantly less controversial. The main talking point was the budget's pro-small business measures, which included an instant $20,000 tax write off. This caused many discretionary retail stocks to rally the day after the budget, with some retailers even advertising small business budget specials.

Source: Kogan

On the data front, the main talking point was the particularly weak Capital expediture ('capex') data which was released in May. Real private capex for the first quarter fell 4.4%, whilst nominal capital intentions for FY16 fell to $104bn against market expectations of $115bn. This will represent a 31% fall year on year. The unemployment rate also fell to a one year low of 6% as 42,000 jobs were added in May, representing the highest year on year increase since 2011. House prices continued to rise, with Sydney and Melboure up 16% and 10% for the financial year respectively. The median house price across the 4 major cities in Australia is now $565,000.

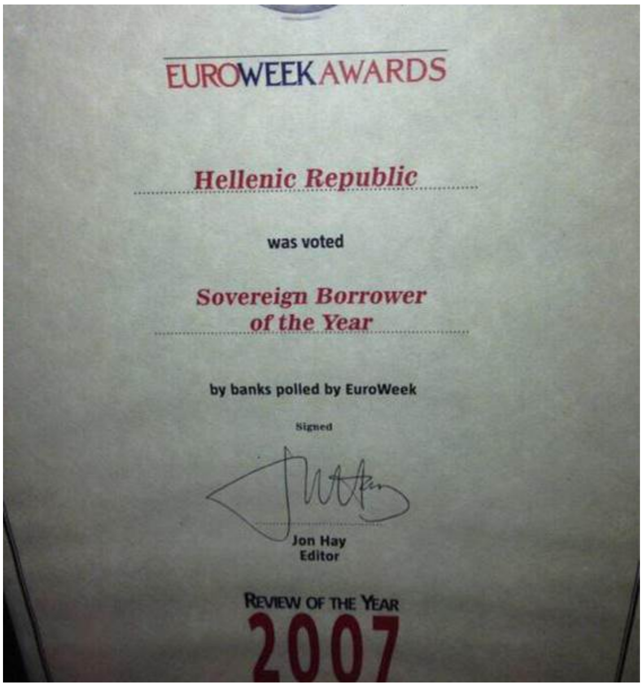


CNN Money publish a 'Fear & Greed' Index based on market volatility, market momentum, safe haven demand, junk bond demand, stock price breadth, stock price strength and put & call options. We last showed this chart as at the September last year, when the reading was 5. The market gained over 4% in the month following.

Greece was the talking point late in the quarter as negotiations to continue the can-kicking of recent years reached crisis point in June. The Australian market fell 4% in the last week of June alone as the Greek government and European creditors failed to reach an agreement, igniting fears of a 'Grexit' from the EU. Greek Prime Minister Alex Tsipras eventually called a referendum for the Greek people to decide whether to accept the creditors' latest terms, in which the Greek population voted 'No'.

"Capital controls within a monetary union are a contradiction in terms. The Greek government opposes the very concept." Yanis Varoufakis, Greek Finance Minister, 28/06/2015

We think EuroWeek may regret handing out this award.



Source: Fitch

Despite the drama emanating from Greece, European data was strong, aided by the front ended stimulus program being implemented by the ECB. Eurozone credit growth was positive for the first time in three years and the EUR/USD cross rate rose 4% for the quarter. In the UK, David Cameron's conservative party won an unexpected majority in the House of Commons.

Elsewhere, New Zealand cut its official interest rate to 3.25% after raising it as recently as July last year. In the US, data was mixed as the change in non-farm payrolls for May was a stronger than expected net-add of 280,000 jobs. This was against market expectations of +226,000 whilst the unemployment rate fell to 5.5%. Housing starts for May however declined 11% month on month to an annualised rate of 1.04m. In China, data continued to weaken as Q1 GDP fell to 7.0% annualised growth (from 7.3%). The People's Bank of China (PBoC) also lowered its economic forecasts from 7.3% annual GDP growth to 7.0% and CPI of 2.2% to 1.4%. The PBoC also undertook a number of stimulus measures during the period; it cut interest rates twice (making it three times in seven months) and it also cut the Reserve Requirement ratio for banks in June. This was the first time since 2008 that the bank has cut the reserve ratio and interest rates simultaneously. These measures were in part to help the country's volatile share market, which we discuss later in the report.

Locally, the IPO market started to cool as a number of floats were either repriced or pulled altogether. The theme of M&A continued, particularly in the Telco space, whilst the confession season of June saw a number of company's downgrade their earnings guidance before the upcoming reporting season in August.

	Jun 2015 Quarter	Year ended Jun 2015
ASX200 Accumulation Index	-6.5%	5.7%
Best performing sectors		
Energy	0.8%	-20.2%
Industrials	-2.3%	16.5%
Telecommunications	-2.4%	25.8%
Worst performing sectors		
Consumer Staples	-10.2%	-10.4%
Consumer Discretionary	-9.5%	3.6%
Financials ex Property Trusts	-9.0%	8.5%

"Would you ever want to buy an airline ticket if the airline says I'm going to sell only half of the plane and charge twice as much money?" BHP CEO Andrew MacKenzie, 18/05/2015

Despite being the worst performing sector for the year, Energy was the best performing this quarter as WTI crude rose 25%. Santos rose 12% for the quarter; as shown below, the first cargo is due at the company's Gladstone LNG project at the end of July.

Figure 2: Banner at GLNG plant site – Bechtel's first LNG cargo target is 31 Jul 2015

Source: Deutsche Bank photo taken at GLNG downstream plant site on 23 Apr 2015, reproduced with permission from Santos

Source: Deutsche Bank

On the M&A front, iiNet received two more takeover offers; this time being an all-scrip bid from M2 Group and increased cash bid from TPG Telecom of $9.55. TPG also acquired a blocking stake in Amcom Telecommunications with the intent on voting against the proposed merger of Amcom and Vocus Communications. Despite this, the merger motion still passed. Elsewhere, BHP spun off South 32, Recall received a takeover offer from US listed records management company Iron Mountain (which is discussed in further detail later in the report) and Warren Buffett's Berkshire Hathaway entered a quota share agreement with Insurance Australia Group.

There were a large number of downgrades during the period, including from Flight Centre, Seek, Virtus Health, Sims Metal and Worley Parsons. IOOF holdings sold off following a Fairfax media investigation into internal misconduct while Slater & Gordon was significantly de-rated by the market after accounting irregularities were discovered in its acquisition of the Professional Services Division of UK listed firm Quindell.

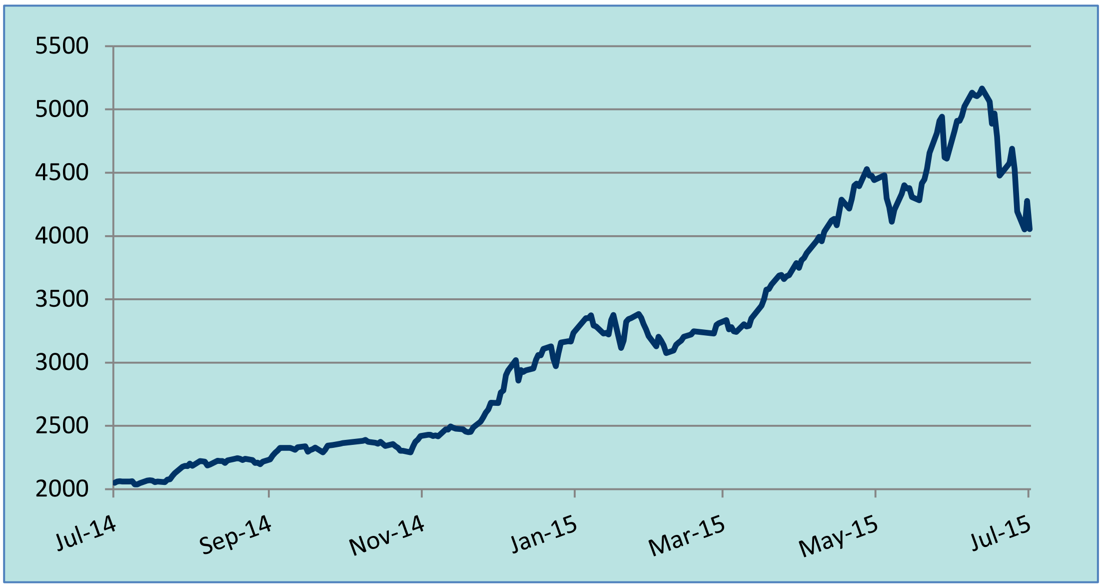
Consumer Staples was the worst performing sector, driven by Woolworths which fell 9% for the quarter. The supermarket giant downgraded its full year profit guidance to ‘broadly in line with prior year’, from growth of 1.8%. The company cited poor trading in Food & Liquor in May and June, with comparable sales for Q4 2015 of -0.7%. CEO Grant O’Brien also announced his retirement from the company after a 4 year tenure.

"Supermarkets is not a complicated business" - Ralph Waters, Chairman of Woolworths 17/06/2015

Chinese share market

The price action in the Chinese share market recently has been nothing short of extraordinary. At its peak in the mid-June, the Shanghai Composite index was up 36% quarter to date, and a massive 150% year rolling. The index then sold off sharply, finishing 17% off its highs, but still up 13% for the quarter. At its peak in June, the combined market cap of the two major Chinese markets (the Shanghai Composite and the Shenzhen Stock Exchange) was US$10 trillion, up from $3.7 trillion a year ago. The country’s market capitalisation is second to only the U.S.A at US$27 trillion.

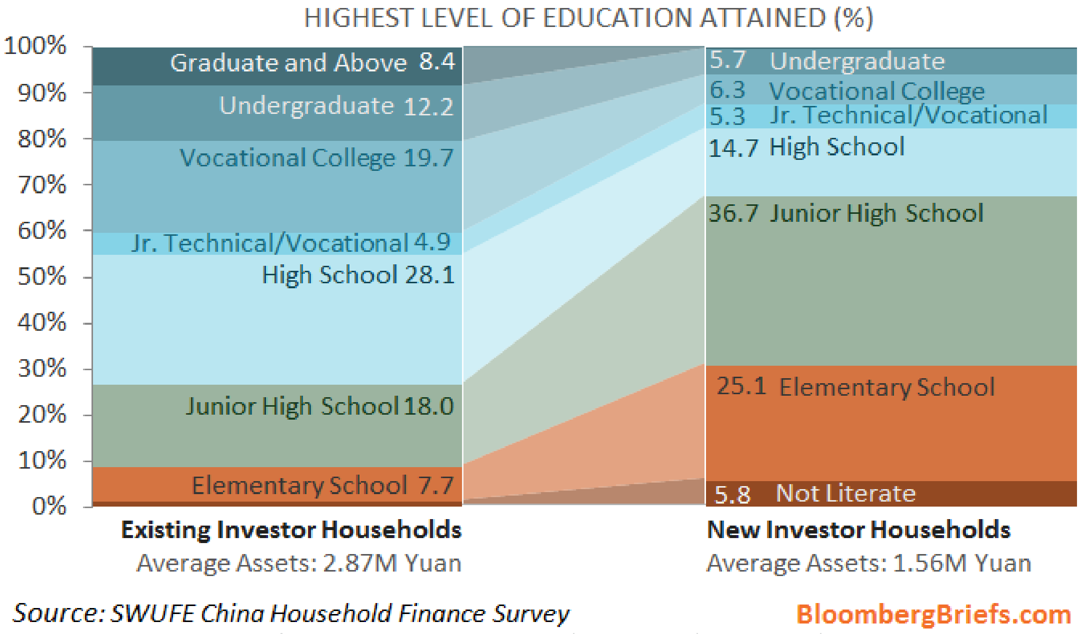
Shanghai Composite Index



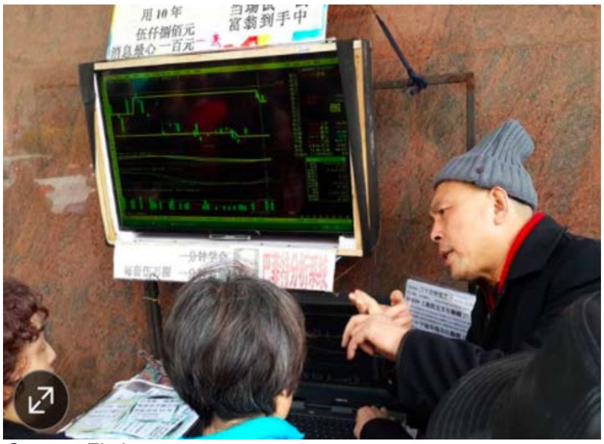
Reforms by the Chinese government to help investors to diversify away from the property market have been the main driver behind the rally. One such reform was the Shanghai-Hong Kong Stock Connect, which allowed investors in each market to easily trade shares on the opposing market with their local stock broker. The Chinese government also recently allowed investors to open multiple accounts, ending the ‘one person, one account rule’, along with allowing over 1,000 Hong Kong mutual funds to be sold in China for the first time.

Worryingly, these reforms are aimed at retail investors who have been seemingly swept up in the momentum. Some estimate that retail investors make up 80-90% of trading activity in China. More than 10 million trading accounts were opened in 2014, which is greater than in 2012 and 2013 combined. Some of the anecdotes we have heard out of China are a cause for concern. These include street sweepers not coming to work due to being too busy trading and farmers in remote villages eschewing crops to buy shares.

As shown in the graph below, 6% of new investors in the market can't read, and junior high school is the highest level of education obtained by 60%.



Source: Bloomberg



Source: Fitch

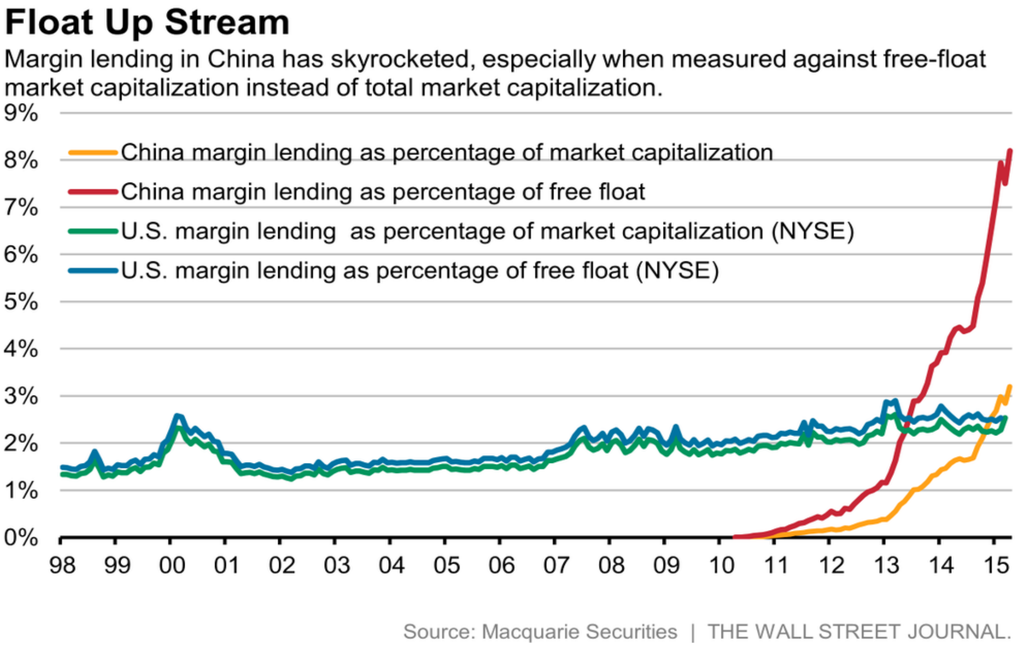
On the street, some more experienced investors are even offering 'one minute lessons' on the trading strategies of Warren Buffett.

Source: Craigs IP

A street vendor keeping a close eye on the market.

As evidenced below, many retail investors have borrowed to get a piece of the action. Recently, there has been some volatile swings in the market due to regulators cracking down on the issuance of margin loans, with some brokerage houses even being suspended. However some brokers in Hong Kong (where commissions are cheaper and margin funding costs lower) are even offering HKD$10,000 travel reimbursement for citizens from the mainland to go to Hong Kong and set up trading accounts.

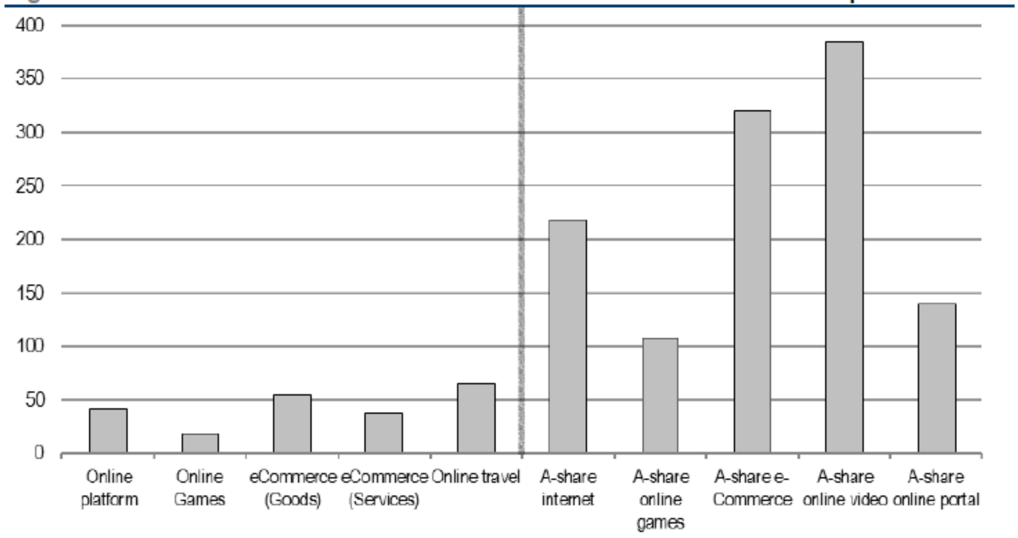
"The worse a situation becomes the less it takes to turn it around, the bigger the upside." George Soros, Investor, 23/01/2015



Source: Macquarie

The scale of the rally has took the average P/E multiple of internet stocks in Shanghai to a dizzying 220x. Meanwhile Chinese internet stocks listed overseas are trading at 40x FY15. A recent trend has emerged whereby China ADR's listed on overseas exchanges such as the NASDAQ have received 'going private' proposals, with the intention of re-listing in the A-Share market to enjoy a large re-rating.

Figure 12: **FY15E P/E—overseas listed Chinese internet stocks vs A-share peers**



Source: Company data, Wind, Credit Suisse estimates

Source: Credit Suisse

"During this process, investors should have confidence and patience, instead of losing their minds and not knowing what to do amid anxiety and panic." – article from 'The People's Daily (official newspaper of the Communist Party), 05/07/2015

In early July, after the market had fallen nearly 30% from its highs in June, the Chinese government suspended initial public offerings and established a market-stabilisation fund to help shore up the stock market. Given the heavy weighting towards retail investors in the market, Chinese officials are wary that the sell-off could hit sentiment and spread to other parts of the economy.

Recall

During the quarter we increased our holding in Recall Holdings (REC). REC is the world's 2nd largest document storage and information management provider, operating in 24 countries with an EBITDA of US$200m. In December 2014, US-based Iron Mountain Inc. (IRM) the world's largest document storage and information management provider, operating in 36 countries with an EBITDA of US$900m, approached REC with a $7.00 implied price per share merger proposal (80% in IRM scrip, 20% in cash), a 39% premium to the price at which REC traded in September 2014 before rumours of an IRM merger proposal surfaced. This proposal was turned down by the REC Board as in their opinion the offer did not reflect the fundamental value of REC and the REC share price continued to increase towards $8.00 during the first quarter of 2015.

In late April, REC and IRM announced an agreed merger (subject to confirmatory due diligence) with an improved offer for REC with an implied price of $7.97 (90% in IRM scrip, 10% in cash). The companies outlined substantial cost synergies of US$125-140m per year from combining the two businesses, resulting in at least high-single digit EPS accretion for IRM. Following a brief lift in the IRM share price reflecting the value uplift from the merger, the IRM share price proceeded to fall from ~$36 to ~$32 due most likely to concerns over anti-trust approval, length of time to transaction close (early 2016) and a negative broking report questioning IRM's ability to sustain (and grow) its current dividend. The REC share price dropped back into the low $7's and we increased our holding.

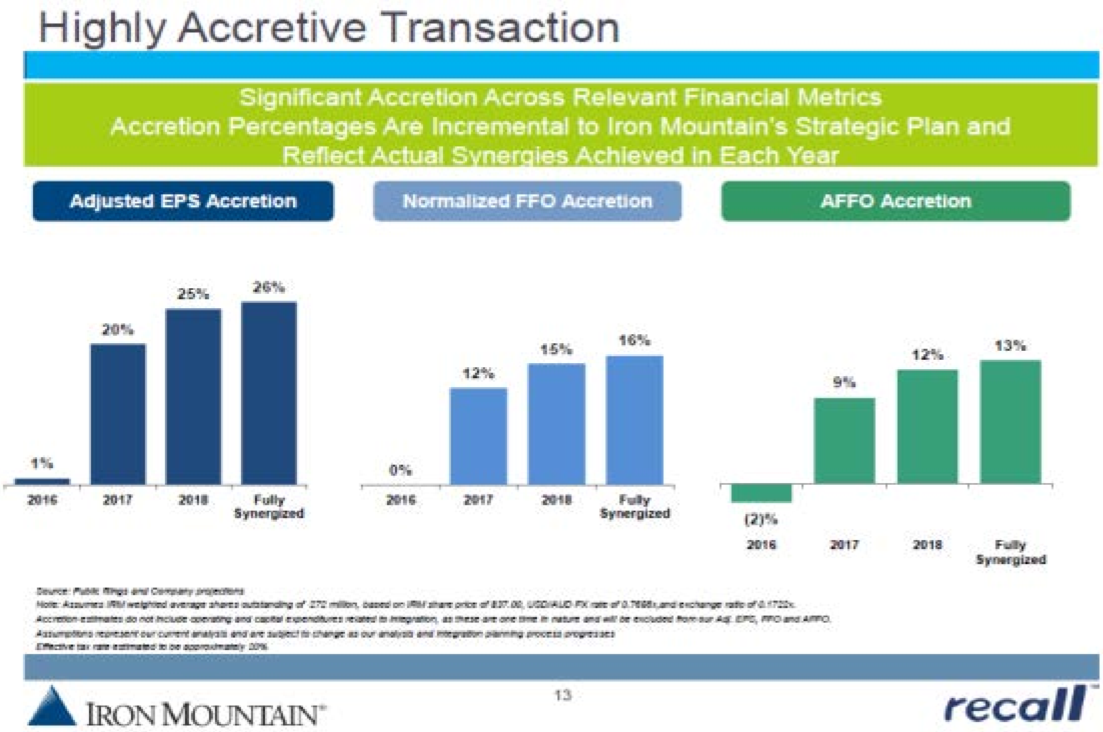
The drop in IRM share price during the due diligence period afforded the REC Board the opportunity to push for better terms, and when the definitive agreement was announced in early June, IRM offered REC shareholders an additional US$0.50 (A$0.65) per share in cash. Importantly the estimated synergies were increased to US$155m per year and despite increasing the cash component of the offer, the transaction was now forecast to be greater than 20% EPS accretive for IRM. Again the IRM share price failed to react positively to the more accretive and definitive merger agreement and the REC share price remained in the low $7's where we continued to increase our holding.

In the low $7's per share, we view the REC stock as offering a very attractive risk-return skew, with fundamental value of REC as a standalone company not far below this level with substantial relatively low-risk upside from the IRM merger including:

- Closing of the 8-12% discount that REC has been trading at relative to the implied offer price – we view the risks of anti-trust clearance and ultimately deal completion as low.
- The merged entity outperforming cost synergy estimates which we view as conservative – REC believe closer to $250m per year is achievable.
- Potential for IRM to re-rate from a 6% dividend yield towards US REIT peers that trade in the 4-5% range, with confirmation of a step-up in dividends in 2017/18 of at least 10% as the synergies are realised and the merged entity de-levers faster than IRM standalone – we are increasingly comfortable with IRM's cash flow coverage of its dividends.
- Further upside from revenue synergies from combining the largest two companies in an industry with favourable attributes of strong emerging market growth and a highly fragmented customer base with low turnover (due to high switching costs and general inertia).

We note that the Chairman and CEO of REC have both been buying REC stock on market at the ~$7 level over recent weeks.

"Together we will certainly be in a stronger position to capture more of the estimated global market opportunity of $23 billion, of which nearly 75% remains un-vended and represents our exciting greenfield opportunity." Bill Meaney, CEO of Iron Mountain, 08/06/2015



Source: REC/IRM

Technology / Cloud Computing

Technology advancement appears to be moving at an increasing speed. At a Credit Suisse conference earlier this year Christian Lanng, CEO of Tradeshift, gave a good explanation for what's driving this. Christian highlighted the exponential nature of Moore's Law[1], in which technological advancements compound over time, hence the pace of change over the next decade will be much greater than during the last. It's an important consideration for investing; with the pace of disruption accelerating, the strength of businesses' competitive advantage will increasingly be tested. With exponential growth in computing power, things like autonomous cars, and artificial intelligence (AI) replacing white collared workers may be closer to reality than we think.

One technological trend that is very visible currently is the shift towards Cloud computing. Up until recently software was predominantly sold on physical discs, or a copy is downloaded from the internet, but in both cases a copy of the software is installed onto the user's PC. Periodically the software vendor will send updates, or require a new purchase of the next version in order to get the latest improvements.

With Cloud based software the user typically pays a lower monthly subscription fee with no lock-in contract for software that sits in the 'cloud', meaning its installed on a central server somewhere, and you access it via the internet. The advantages are numerous - for users it can mean lower upfront costs, less need to run in-house servers and the cost and complexity that comes along with it, and you constantly have access to the vendor's latest version of the software. For software vendors revenue is smoothed out, distribution costs are lowered, and new updates can be rolled out more frequently.

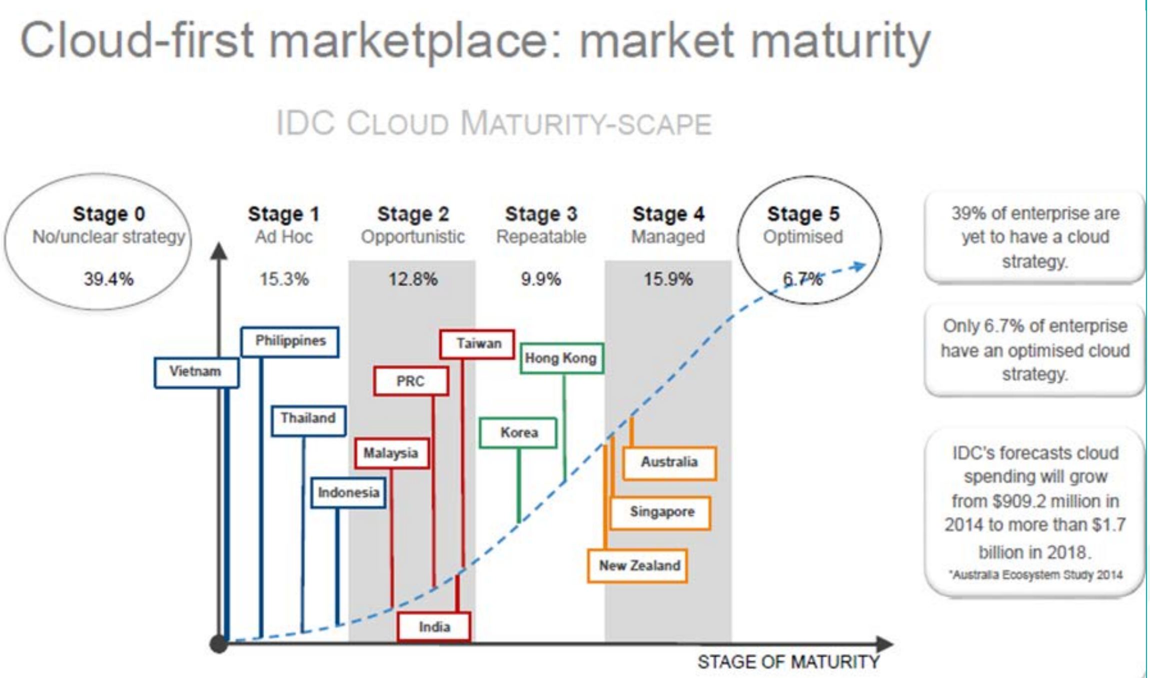
"I don't need a hard disk in my computer if I can get to the server faster… carrying around these non-connected computers is byzantine by comparison." Steve Jobs, 1997

[1] Moore's Law - Per Wikipedia - the observation made by the Intel Co-founder, Gorden Moore, in 1965 (revised in 1975) that, over the history of computing hardware, the number of transistors in a dense integrated circuit has doubled approximately every two years.

Source: Google

There are some hesitations for the move to Cloud-based software - mining applications are typically more tailored to individual clients, for high transactional applications latency can be an issue if you have a slow internet connection, and concerns around what happens when there is a network outage. However, the shift looks inevitable over time, with some large software vendors betting their business on it, e.g. Microsoft now describe their strategy as "Mobile-first, Cloud-first", their new Office package (Office 365) is exclusively cloud based and the launch of Windows 10 at the end of July is expected to further move their platform towards the Cloud.

We have identified a number of Australian listed companies that are benefiting from the shift to cloud computing and expect the trend to remain positive over a number of years. The chart below from Rhipe shows that whilst Australian businesses lead Asia in cloud adoption, less than 7% have taken full advantage of the move to date.



Source: Rhipe

Overseas Trips

This quarter we travelled to the US, New Zealand and Asia twice each, and also took one research trip to the UK.

US observations

- Generally underwhelmed with macro-economic activity not accelerating noticeably. The positive being it's not decelerating either, just stable at a low growth rate. The fear factor surrounding the potential 'Grexit' and eventual interest rate hikes appears to be keeping people grounded.
- Despite oil price weakness, the Texas economy is holding up well. Dallas continues to grow strongly, adding 1,000 jobs per month.
- Companies are finding it hard to find people to employ in California. One contact noted that "good entry level workers are very hard to find and then keep, despite paying way above minimum wage".
- Healthcare companies are very focussed on costs and focussed on volume growth over price. "Obama Care" observed to be making a clear impact.
- The catch cry was 'disruption' followed by 'Omni-channel'. Most corporates we met couldn't resist weaving these into their 'story'.

"I can say that in terms of not just managing the government, but moving the country forward, we've had a lot more hits than misses. We've made a difference in people's lives. And that is ultimately what you're looking for." Barack Obama, President of the United States, 22/06/2015

Berkshire Hathaway 2015 AGM

Whilst in the US we dropped into Omaha to see Berkshire Hathaway's AGM which also coincided with its 50th year anniversary. It was encouraging to see Warren Buffett and Charlie Munger, now 84 and 91 respectively, still as mentally sharp as ever and keen to espouse their thoughts on investing and lessons in life. Below we've included a few quotes from the AGM's Q&A session:

Charlie Munger:

- "If people weren't so often wrong, we wouldn't be so rich."
- "We're just swimming all the time and just let the tide take care of itself... The problem with making all of these macro predictions is that people come to think that they know something. It's much better just to say you're ignorant."
- "If inflation goes out of control, you never know how it will end up."

Warren Buffett:

- "The more people react from short term events, the more it allows people to make a huge amount of money from securities… In 1973/74 we were able to buy securities cheaper than in 2008/09…. If you're a young investor and can stand back and invest no matter what people are saying, and perhaps sell when everyone is enthusiastic, it's really not a hard intellectual game if you can control your emotions."
- "The CEO should have some real understanding of investments and investment alternatives … I've seen a lot of businesses, run by people that really don't understand the math of investing or capital allocation very well."
- "Charlie and I run into more dysfunctional people with 160 IQs than probably anyone alive."
- "When you get old you have the reputation you deserve, you can fool people for a while, but ultimately you'll get the reputation you deserve."
- "Habits make a big difference in life."
- "Money is so cheap at the moment it causes people to do almost anything on the asset side."

"Cash, though, is to a business as oxygen is to an individual: never thought about when it is present, the only thing in mind when it is absent." Warren Buffett, 15/03/2015

Asia technology observations

- There is now materially less need for private companies to IPO. It's taking 3 times longer for companies to IPO today vs 2 years ago, and there are 92 'billion dollar' private companies (valuation based on most recent private placement capital raisings), of which 60 are in the US with a total value of $160bn (which is less than half the Microsoft market cap and around 70% of the Facebook market cap).
- Key trends that tech/online companies are leveraging include;
  - (1) cloud;
  - (2) machine learning;
  - (3) big data; and
  - (4) proliferation of mobile.
- Consumers want access and not ownership (e.g. Air BnB, Uber), mobility with instant and relevant offers (location services enabled tailored offers), ability to transact seamlessly (integrated payments), seamless devices (smart home) and smarter, wearable technology that assists in quality of life.
- Online classified markets in China remain well under-priced given the focus is predominately on growing market share. For the price 2 large bottles of San Pellegrino at a hotel, you can post 6 jobs ads, or you can sell a car.

Outlook

The market pulled back on concerns around bank capital, low revenue growth and continued weak commodity prices. Furthermore Greece defaulting on loans, China continuing to struggle with capital outflow management and US bond yields creeping up added to the bearishness.

Since we failed to predict what would occur now, why would anyone ask us to predict the future". Charlie Munger, May 2015

From the current lower market levels and some lowering of growth expectations, the Australian market does look more attractive as reflected in a recent pick-up in M&A activity. Greencape expects the better management teams should excel in this environment where capital allocation skill comes to the fore. Greencape has deployed some of the cash we built up from profit taking last quarter; however we have kept some powder dry leading up to the upcoming reporting season. The market's bearish tone means companies missing short term numbers will be harshly dealt with, and upside surprises very rare.

More information

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

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Email Greencape at: **bdm@greencapecapital.com.au**

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