Greencape Wholesale High Conviction Fund

Quarterly report - March 2014

Performance #	Quarter %	1 year %	3 years % p.a.	5 years % p.a.	7 years % p.a.	Inception % p.a.
Fund return	1.36	14.66	9.26	14.30	6.69	9.87
Growth return	1.03	10.81	5.56	10.78	1.66	4.96
Distribution return	0.33	3.85	3.70	3.52	5.03	4.91
S&P/ASX 200 Accumulation Index	2.09	13.46	8.54	13.39	2.98	5.49
Active return^	-0.73	1.20	0.72	0.91	3.71	4.38

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

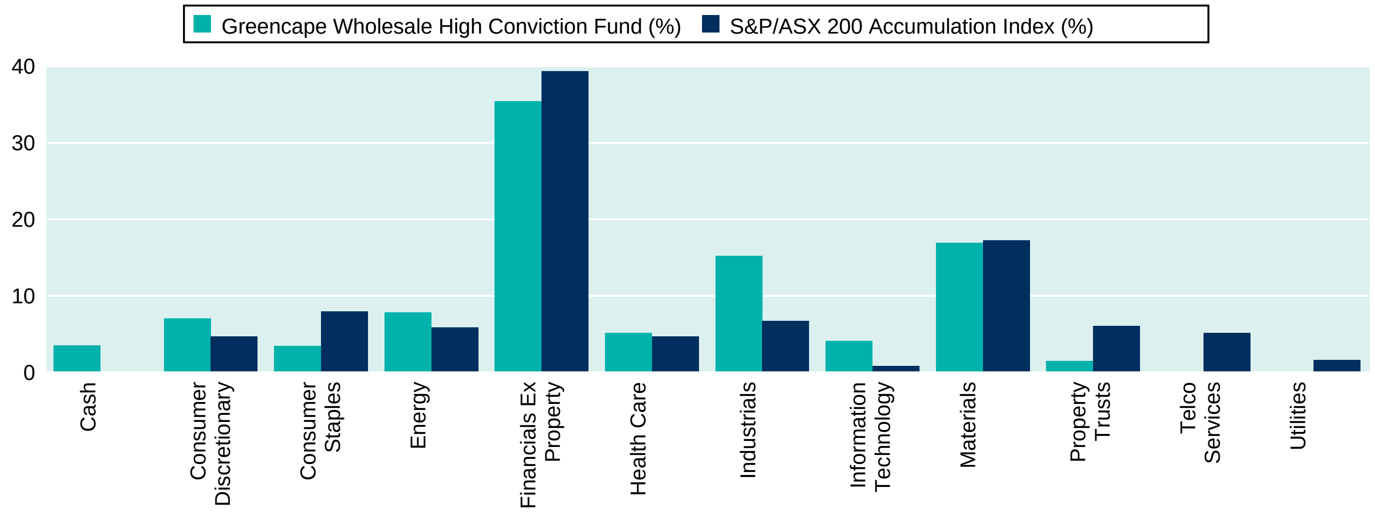
At least five years

Asset allocation	As at 31 March 2014 (%)	Range (%)
Security	96.50	85-100
Cash	3.50	0-15

Fund facts	
Inception date	11 September 2006
APIR code	HOW0035AU

Fees	
Entry fee	Nil
2012-2013 ICR	0.90%
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	+0.30% / -0.30%

Sector exposure as at 31 March 2014



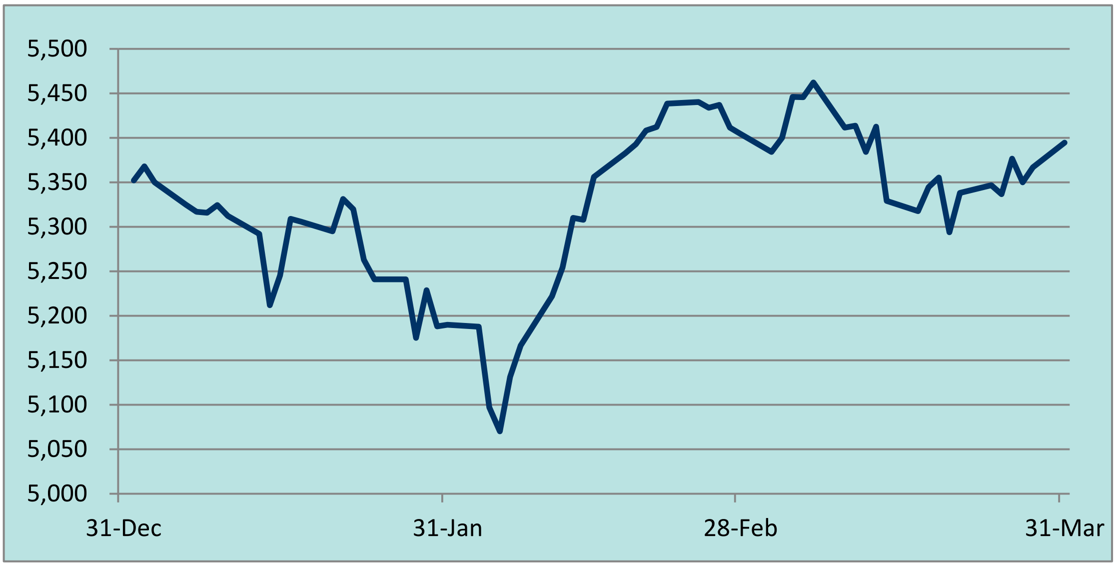
Fund performance summary

The S&P/ASX 200 Accumulation Index returned +2.09% for the quarter. The fund underperformed the market and delivered a +1.36% return over the quarter.

Market overview

After two successive calendar years of double digit growth, the market again managed to push higher for the quarter, albeit modestly. Macro headwinds saw the local exchange post losses in January, before bouncing back during a stronger than expected February reporting season, ahead of a relatively subdued March. The Reserve Bank of Australia (RBA) continued to talk down the Aussie dollar and the flood of IPO's seen in the December quarter eased, with a number of them either repriced or withdrawn.

S&P/ASX 200 Price Index



The RBA again chose to sit on their hands for both meetings during the quarter, making it 8 months since the cash rate was last changed in August 2013. This is expected to continue, with the RBA governor Glenn Stevens recently noting publicly that stability in interest rates 'could be expected given the current economic conditions'. While not aggressively talking down the dollar this quarter, the RBA still noted that the 'the exchange rate remains high by historical standards'. Local economic data was generally mixed. Retail sales in January increased by 1.2%, against the market which was expecting only 0.4% growth. Real GDP for Q4 2013 rose 0.8% against market expectations of 0.7%. Employment numbers surprised on the downside by a cumulative total of over 51,000 in January and February, before then surprising to the upside by 32,000 in March. The unemployment rate rose to a ten year high of 6.0% in February.

One of the major themes of Governor Steven's speech was how best to manage the transition to more sustainable east-coast focused growth now that mining investment is declining. As we can see below, wages in mining services and building related sectors have been hit hard in the past year.

Profession	2012	2013	% decline
Construction Planners	120,467	95,053	-21%
Materials Handlers	125,130	105,503	-16%
Environmental services assistants	70,538	61,718	-13%
Engineering drafts people	85,355	78,201	-8%
Construction estimators	110,410	98,288	-11%

Source: Seek

"There is something of a tendency for governments, when asked to outline their growth plans, to list the things that they already want to do for political reasons, and then to claim that they will help growth. Some of those things may well help growth, but in fact many of the things that are needed to spur growth seem not to make it onto such lists." Glenn Steven, Governor of the RBA, 03/04/2014

The US Federal Reserve twice chose to slow down its unprecedented asset purchase program by US$10bn during the quarter. The current rate is now $55bn per month.

"Remember the late Barton Biggs' observation: A bull market is like sex. It feels best just before it ends." Warren Buffet 18/03/2014

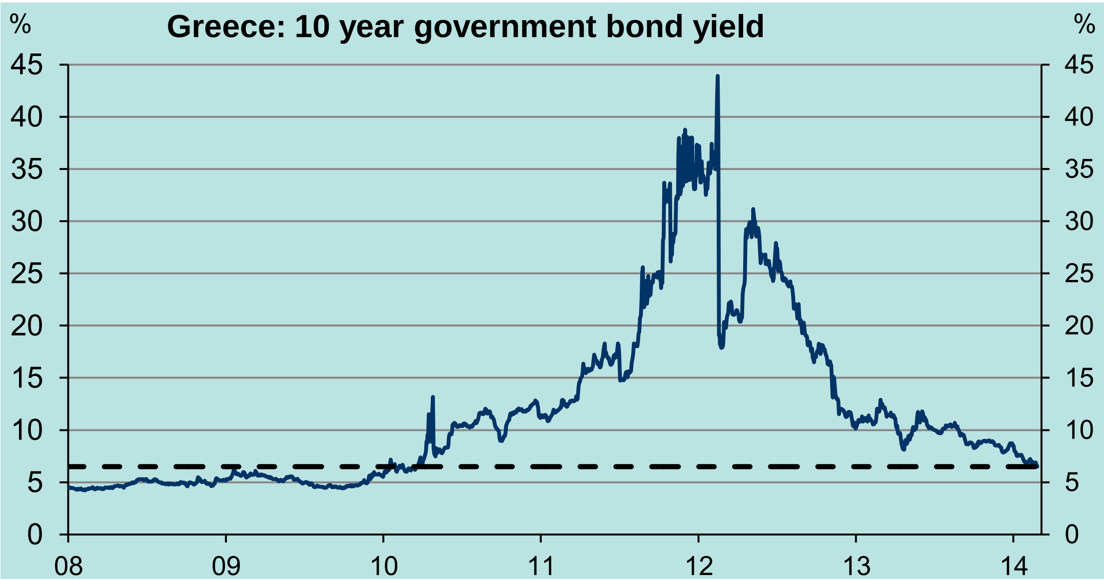
The cold snap on the East Coast of the US impacted economic data during the period, however this was largely brushed off by investors as US stock indexes surged to fresh all-time highs. The adverse weather conditions saw the US unemployment rate rise month on month for the first time since December 2012. Contrary to Australian figures, US retail sales for January declined 0.4%, with market expectations for flat growth on December's number. The US unemployment rate continued to fall, with the rate now standing at 6.7%, a post GFC low, albeit contributed to by a lower participation rate. The manufacturing ISM index for January fell to 51.3 against market expectations of 56.0, a sizeable miss.

Emerging market fears reared their head again during the period, which saw markets sell off in January. In particular it was China which (not surprisingly) affected our market most profoundly. The official PMI fell each month, the reading for February (announced in March) of 50.2 was an 8-month low. Industrial Production year-to-date as at the end of February also surprised to the downside, with an increase of 8.6% versus expectations of 9.5%, this was the lowest print in nearly 5 years. However official GDP rose 7.7% year-on-year for Q4 2013, slightly beating expectations of 7.6% growth. Concerns over China's shadow banking system continued to cause concern for the market. We expand on this later in this report.

Other emerging markets hit included Turkey, which saw its currency, the Lira, fall to record lows on capital outflows before its central bank stepped in and increased interest rates. Argentina again found itself in trouble as the Peso fell after the government reiterated its commitment to capital controls. Elsewhere, tensions between Russia and Ukraine escalated over control over the Crimean Peninsula.

Europe continued its trajectory of a tepid recovery, with the Euro Stoxx index gaining 2% for the quarter. Eurozone GDP rose 0.5% for Q4 2013, beating market expectations of a 0.1% gain.

The share market in Greece has staged a particularly impressive recovery, surging over 65% from July 2012 lows. Greek bonds yields which were very much on the nose in mid-2012, are now trading at pre-crisis levels, as shown below.



Source: Deutsche Bank

Locally, the market was preoccupied with February's reporting season, which was preceded by the 'confession' season with many companies' downgrading their guidance. Information Technology was the best performing sector, led by Computershare who posted a half year result which beat market expectations by 7%, and also upgraded full year guidance of 5% Management EPS growth to between 5-10%. The company cited realisation of synergies from the Shareholder Services acquisition, increased utilisation of offshore processing capabilities and general cost focus throughout the group as the drivers behind the result. Carsales.com also posted strong gains after it announced it will acquire 49.9% of SK Encar, a South Korean automotive trading business.

	Mar 2014 Quarter	Year
ASX200 Accumulation index	2.1%	13.5%
Best performing sectors		
Information Technology	6.5%	17.6%
Utilities	4.4%	5.8%
Financials (ex Property Trusts)	3.8%	20.3%
Worst performing sectors		
Consumer staples	-0.9%	2.5%
Materials	-0.4%	7.7%
Telecommunications	0.3%	21.2%

Despite usually underperforming a rising market due to their defensive nature, Utilities were the second best performing sector in the market during the quarter. APA led the way after it posted a strong first half result, beating market expectations by over 8% at the EBITDA line. The result was aided by better than expected contributions from the company's Energy Infrastructure division, in particular from its operations in Queensland and Western Australia. The result was also helped by a by a one-off customer contribution in the company's Asset Management Business of $17m.

"Investing, when it looks the easiest, is at its hardest. When just about everyone heavily invested is doing well, it is hard for others to resist jumping in." Seth Klarman, Oaktree, 20/06/13

Financials also fared well during the quarter. Despite a fire breaking out at the developer's Barangaroo project, Lend Lease outperformed the market. The company posted a solid first half result, with better than expected performance in Asia, Europe and the Americas. Macquarie Group also performed well after the company issued an earnings upgrade in March. Management had previously guided to 40% growth on NPAT, but now expects 40-45% growth due to improved market conditions in the group's Fixed Income, Currencies and Commodities (FICC) businesses.

Consumer Staples were the worst performing sector for the quarter. Treasury Wine Estates tumbled after issuing a profit warning in January, which saw EBITS guidance revised to ~ 20% below market expectations for the full year. Management cited price increases and less promotional activities in Australia, together with significant competitive activity, as causing higher than expected volume declines. In Asia, management noted that China's government crack-down on extravagance was impacting consumer demand for premium wine. Coca-Cola Amatil also struggled after the company posted a result which was marginally below market expectations at the bottom line, but highlighted competitive pressures in the domestic market with a 9% decline in Australian beverage earnings.

Materials struggled during the period, mainly as a result of the spot iron ore price falling over 10% in two trading sessions, before bouncing back to close only 2% lower for the quarter. Companies which derive a significant amount of their earnings from iron ore, such as Rio Tinto, Fortescue and Atlas Iron were sold off harshly and underperformed for the quarter. Spot gold bounced back for the quarter, gaining 6.5% which saw gold miner Newcrest up 26%. James Hardie outperformed after the building materials company declared a special dividend of 28cps and upgraded earnings guidance for adjusted NPAT by 4%, reflecting ongoing improvement in the US and European Fibre Cement businesses.

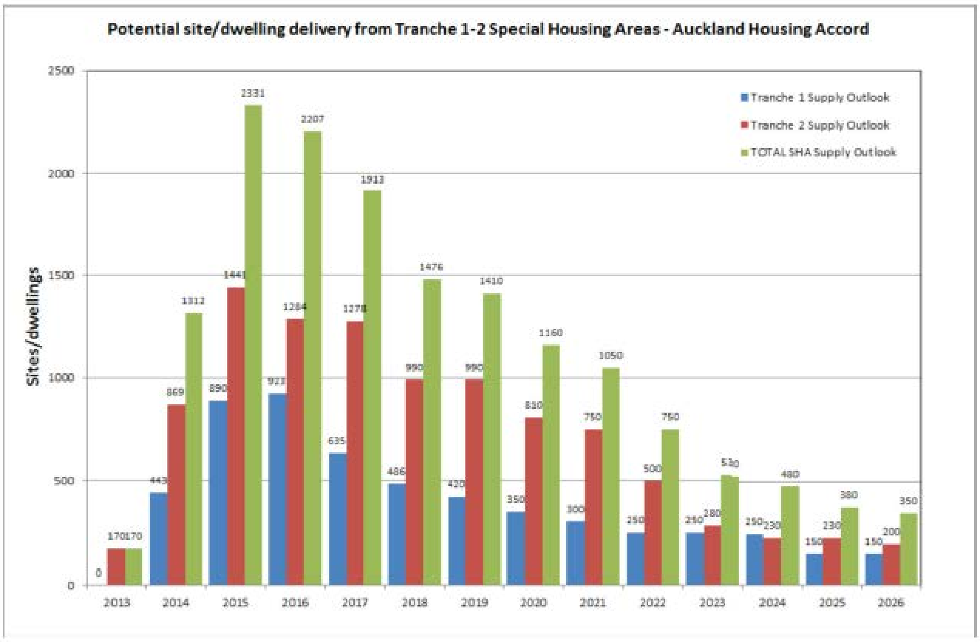
Telecommunication Services, while posting a positive performance, still underperformed the market for the quarter. Telstra (which dominates the sector), fell after it announced the sale of 70% of Sensis for $454m to a US private equity firm. This implies a 100% business value of $649m, which was well below market valuations of between $1.5bn-$2.9bn.

Micro observations

During the quarter we undertook a trip to New Zealand to gain a better understanding of the sustainability of demand across residential and commercial property construction, which is predominantly relevant to one of our portfolio holdings, Fletcher Building (FBU).

- We were surprised how far in the space of 6 months the Auckland council has come in opening up land supply via "Special Housing Areas";
- In addition, the proposed Auckland Unitary Plan will bring consistency to building and planning laws across Auckland (there are currently 14 different plans) helping the pace of development by reducing bureaucracy, a key complaint of large scale developers;
- The general consensus from the building industry is that the Auckland Council are commercial and have their best people involved, which is a strong positive towards the sustainability of housing supply in the market;
- The contacts from other building materials companies we spoke to were bullish on the pipeline level of commercial activity;
- The Christchurch reconstruction cost estimate is rising, with feedback that the official number is now closer to NZ$45bn (up from $40bn);
- Overall, the Christchurch rebuild remains a case of a flatter profile and longer duration compared to original estimates;
- CBD spaces are becoming more attractive as the Government commits to anchor projects, however the cost of commercial leases may end up higher than expected.

"It is in the self-interest of governments to treat capital providers in a manner that will ensure the continued flow of funds to essential projects." Warren Buffet, Investor, 18/03/2014



Source: Auckland Council

The chart above shows the outlook of growth in potential site deliveries in Auckland over the next 12 years. As you can see the growth off the 2013 base is substantial and then tapers off gradually until 2026.

Overall, the conclusion we took out of this trip was that the New Zealand market remains a strong tailwind for FBU and have noted a number of earnings drivers that will assist in future earnings as other areas roll off. FBU also remains well placed to win its fair share (or more) in New Zealand's commercial market.

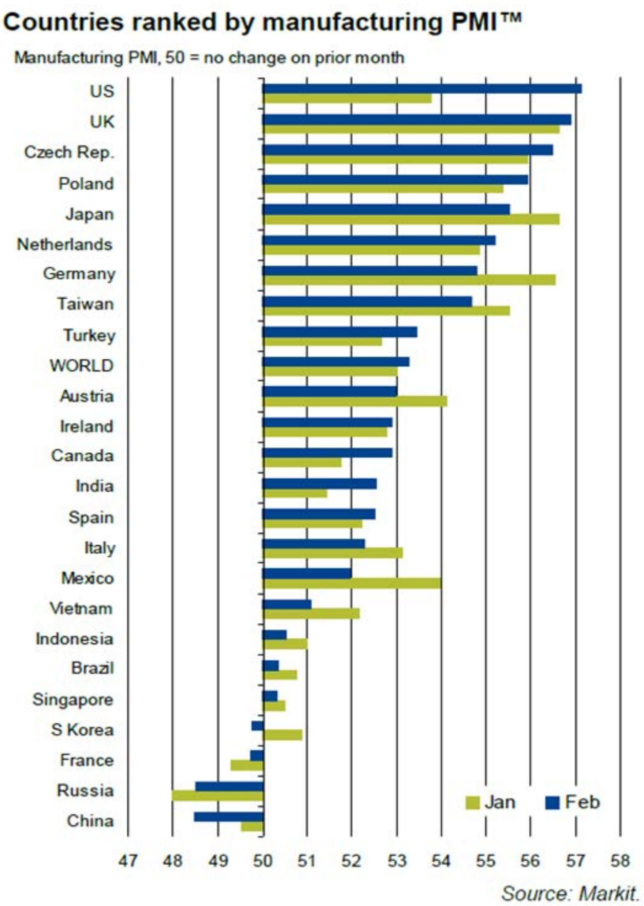
Macro observations

China

During the quarter we saw perhaps the first signal from the Chinese government that it will not stand behind debt-laden firms which default on their obligations. Haixin Steel, a privately owned steel mill in China's northern Shanxi province, was the first report of a steel mill default. Loose credit has allowed loss making steel mills to effectively be subsidised in the past, despite their operations being uneconomic. Reports suggest that the government allowed Haixin Steel, among other small privately owned companies, to default to help address the issue of 'moral hazard' in the economy. These defaults were partly to blame for the flash crash in Iron Ore prices during March, which fell over 10 percent in a matter of days.

In his annual press conference in March, Chinese Premier Li Kequiang was quoted as saying defaults in China were 'hardly avoidable' as the government accelerates financial deregulation in the economy. However it should be noted this was not a normal press conference; it was a carefully managed event with pre-selected questions. Li, who is the country's second in charge also made some other significant remarks during the conference pointing to a shift in policy. Importantly, Li announced that China could accommodate growth lower than its stated target of 7.5% while noting that that the focus of the government was not to pursue growth for growth's sake, but to improve the quality of economic development. Li also acknowledged weaknesses such as terrible pollution, high debt and market inefficiencies which need to be addressed; however a balance needs to be struck between ensuring economic expansion and structural reforms. These reforms appear to be at odds of the government's former fixation of growth at all costs, which saw the Chinese government undertake record stimulus spending in the years following the GFC. The new economic stance is decidedly more conservative and importantly, less pro-fixed asset investment.

Although the world may be fixated on the China growth story, the US, still the world's largest economy, had the best Manufacturing PMI reading for February, while China had the worst reading for countries in which the PMI is measured.



"The banking sector has extended $14 trillion to $15 trillion in the span of five years. There's no way that we are not going to have massive problems in China," Charlene Chu, Autonomous Research, 01/02/14

"Decades of intervention by China's government have trained us all to believe that a market is not a natural system but instead something that is merely an elective for a growing economy." Anne Stevenson-Yang, J Capital Research, 03/04/14

"We do not want to let today's stepping stone become tomorrow's stumbling block." Li Keqiang, Premier of China, 13/03/2014

In previous quarterlies, we have discussed China's burgeoning Trust and Wealth Management Products markets, which in turn funds the country's shadow banking system. Investors have been piling into these high-returning products en masse in the search for yield and in the widespread belief that the government or issuing bank will stand behind any defaults. During the quarter, a financial trust product narrowly avoided default when it was bailed out at the eleventh hour. Some economists predicted that if the default eventuated, a Lehman-like domino effect could have torn through the economy. Our understanding however is that due to such products being outside the fractional banking system, a default in and of itself should not cause mass contagion. What is hard to predict however is the impact such defaults may have on investor confidence across China and on property prices, as many of the borrowers are property developers.

Overseas trips

In addition to New Zealand discussed above, during the quarter we also travelled to the US (twice), China, and Macau. Some of our key observations are shown below:

USA observations

- Compared to our last trip in September, the economy appears stronger but not convincingly so, and without a lot of momentum;
- Capital expenditure cycles still appear muted, and the low end consumer is yet to show his/her face; however housing construction continues to grow and commercial construction is marginally better;
- Lack of funding is still an issue for commercial and infrastructure spending but there are some encouraging early signs;
- The Texas region is very strong, pro-business Government helping with significant pipeline of business, with one contact noting there are "$60bn of petro-chemical projects on the drawing board";
- In an example of just how severe the winter has been, Lake Michigan in Chicago was 87% frozen over this year versus 50% typically on average;
- "Pent up demand" for housing was consistently mentioned however national builders are gaining more share due to inability of smaller builders to get funding / access to land banks;
- Demographics for home builders remain very supportive however we are in a period where the impacts of recent regulation is more uncertain;
- Finding tradesmen is starting to be an issue for smaller builders but at this stage is still manageable for large scale builders;
- People are starting to look at doing up kitchens and bathrooms at the moment, before really spending on the outside;
- US corporates seem obsessed with buybacks with the hit rate of companies we visited being over 90%. One large corporation we met was buying back stock despite digesting a big and recent acquisition, and gearing of nearly 6x EBITDA;
- Shareholder activists / agitators are more and more commonplace with a growing number of funds set up with this express purpose;
- The term BRIC's has evolved to BIC's as corporate America seeks to distance itself from Russia;
- Cloud computing plays have had the share price benefit of being in loss and therefore unable to be anchored to a PE! More than one commented that they want their share price lower as material share price performance was a barrier to attracting new talent (but makes existing talent very sticky!);
- Amazingly US lending covenants are looser today that they were just prior to the GFC – having said that corporate gearing is more moderate versus then.

China/Macau Observations

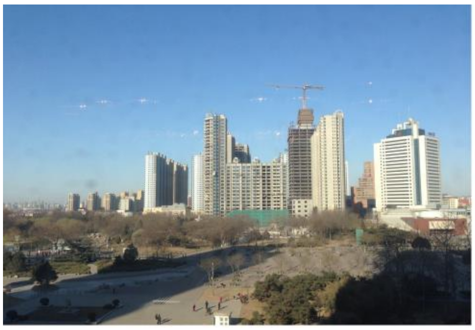
- The risks to consensus Chinese steel production forecasts appear skewed to the downside absent any significant government stimulus policy announcement. Almost all we spoke to expect no such stimulus package;
- Political reform appears to be serious, with companies and banks adhering more closely to government set mandates (e.g. pollution restrictions and no-increased lending to particular sectors) than they were previously;
- Steel mills are facing very tight credit market conditions as well as government mandated spending requirements to reduce air pollution, both of which look like structural headwinds that will remain. This could see further closure of steel mills in the coming months, particularly in Hebei province;
- End user demand growth for steel has been sluggish out of what seems to be becoming an extended

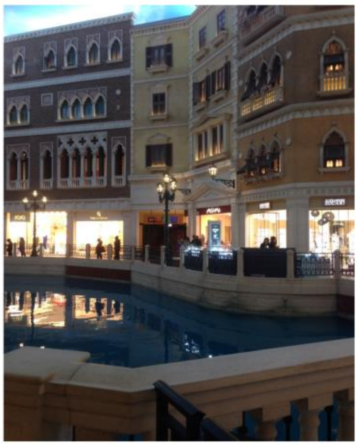
"Labor market slack has also surely been a factor in holding down compensation. The low rate of wage growth is, to me, another sign that the Fed's job is not yet done." Janet Yellen, Chair of the Federal Reserve Bank, 31/03/2014

"I abandoned free market principles to save the free market system." George W. Bush, 16/12/2008

Chinese New Year holiday season, something which was also witnessed as a benefit to Macau's casinos;

- The slowdown in mainland China appears to have had no impact at all on Macau's strong gross gaming revenue growth;
- Average bet sizes in Macau continue to soar (doubled in last 2 years) to the point where the minimum bet on a table during the daytime on most table games we saw was A$70, and approximately double that at peak times at night! Despite this, Casinos have seen no negative impacts on their gaming turnover;
- With such strong growth driven mainly by larger average bets, casino operators should see continued profit margin expansion;
- Abuse of China UnionPay (payment system that allows Chinese people to withdraw up US$150k per day) appears to be widespread, and any crack-down by the government could be very detrimental to the casino operators if it were to occur.





Top left: A clear day in Tangshan (major steel producing hub). In our Sep 2012 trip, visibility was ~200 metres due to pollution! **Top right:** Wynn Casino, Macau **Bottom left:** Inside the Venetian Hotel, Macau **Bottom right:** New Guangzhou railway station which connects with Macau

Outlook

Greencape observes the US economy is doing better than 'flat' and after several years, finally some top line momentum can be expected. We expect operating leverage will surprise on the upside for a number of stocks exposed to the US. Europe is observed as 'flat-ish' whilst China keeps growing, albeit at a slower rate and with a higher than expected proportion of fixed asset investment spend continuing to drive the momentum. This is considered low quality growth and risks adding further weight to an already over-indebted corporate sector, and hence we remain concerned. Our observations on the Australian economy is that it remains very patchy. Stock specific factors are more important and management competency is extra valuable in this environment.

The strong performance of the market over the last 12 months now demands earnings delivery. Growth and earnings certainty is relatively scarce and commands a deserved premium. This is expected to remain the case, and failure to deliver on expectations will be very painful in this market. So other than selected US facing stocks, macro tailwinds remain scarce and self-help earnings drivers remain key. It remains very much a stock picking market, hidden value opportunities appear limited but very well rewarded once discovered.

"Whoever said 'It's not whether you win or lose that counts' probably lost." Martina Navratilova

"(George) Soros has taught me that when you have tremendous conviction on a trade, you have to go for the jugular. It takes courage to be a pig." Stan Druckenmiller, Investor

More information

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

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