Greencape Wholesale High Conviction Fund

Quarterly report - September 2015

Performance #	Quarter %	1 year %	3 years % p.a.	5 years % p.a.	7 years % p.a.	Inception % p.a.
Fund return	-4.81	1.18	10.96	8.02	7.96	8.52
Growth return	-5.19	-10.77	2.10	1.36	2.44	2.17
Distribution return	0.38	11.95	8.86	6.66	5.52	6.36
S&P/ASX 200 Accumulation Index	-6.58	-0.68	9.35	6.55	5.93	4.52
Active return^	1.76	1.86	1.61	1.47	2.03	4.01

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

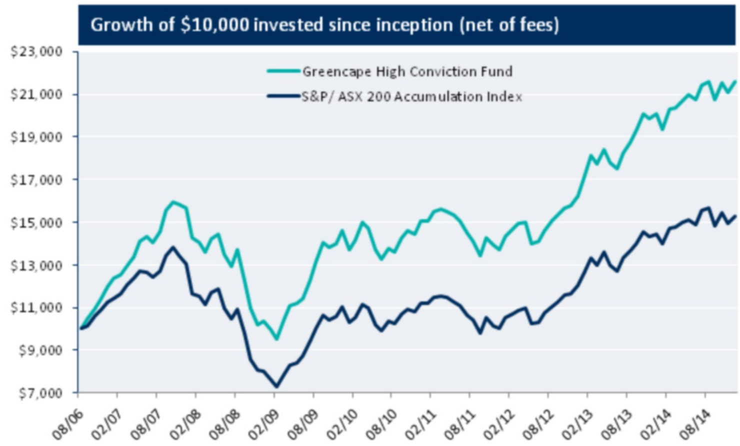
Greencape is an active, 'bottom-up' stock picker. Whilst Greencape does not target any specific investment style and will invest in stocks displaying 'value' and 'growth' characteristics, its focus on a company's qualitative attributes will generally lead to 'growth' oriented portfolios. This is an outcome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

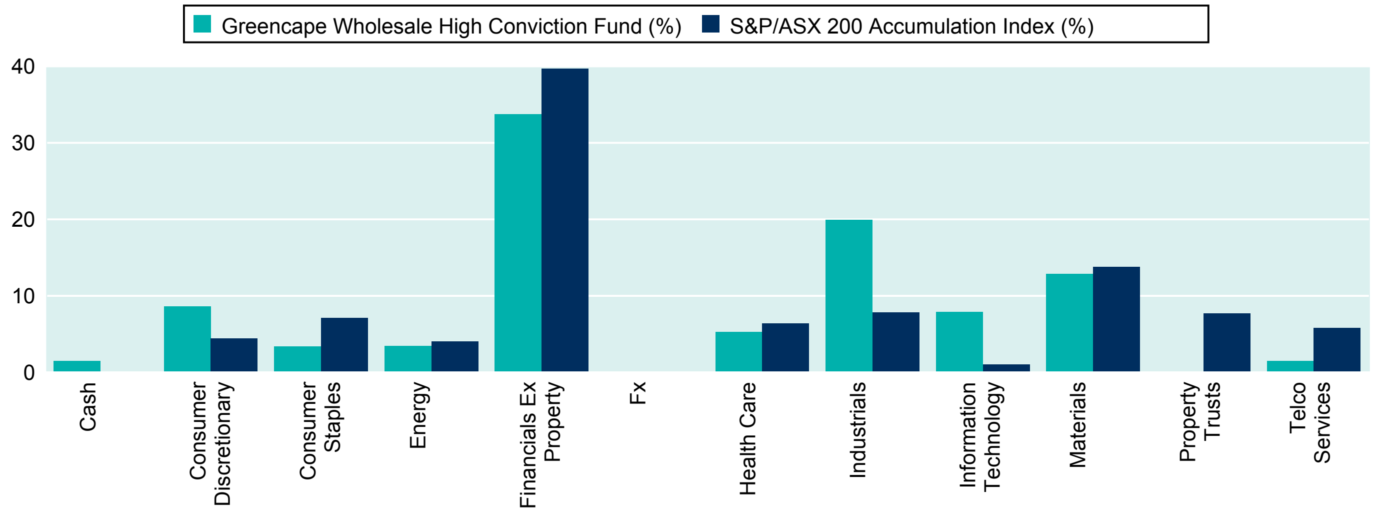


Asset allocation	As at 30 September 2015 (%)	Range (%)
Security	98.51	85-100
Cash	1.49	0-15

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 September 2015



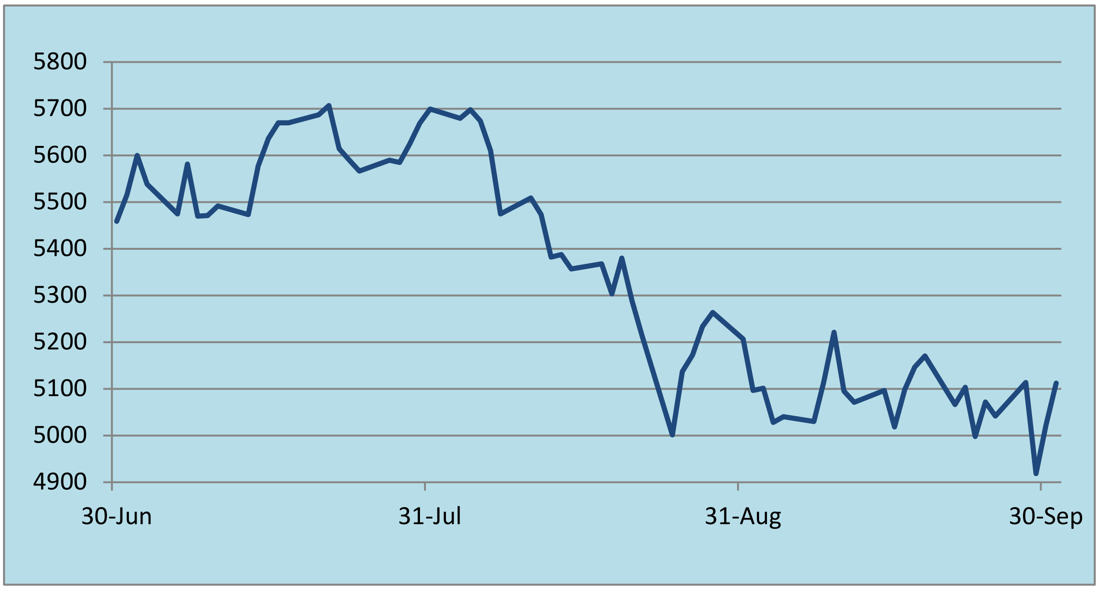
Fund performance summary

The S&P/ASX 200 Accumulation Index returned -6.58% for the quarter. The fund outperformed the market and delivered a -4.81% return over the quarter.

Market overview

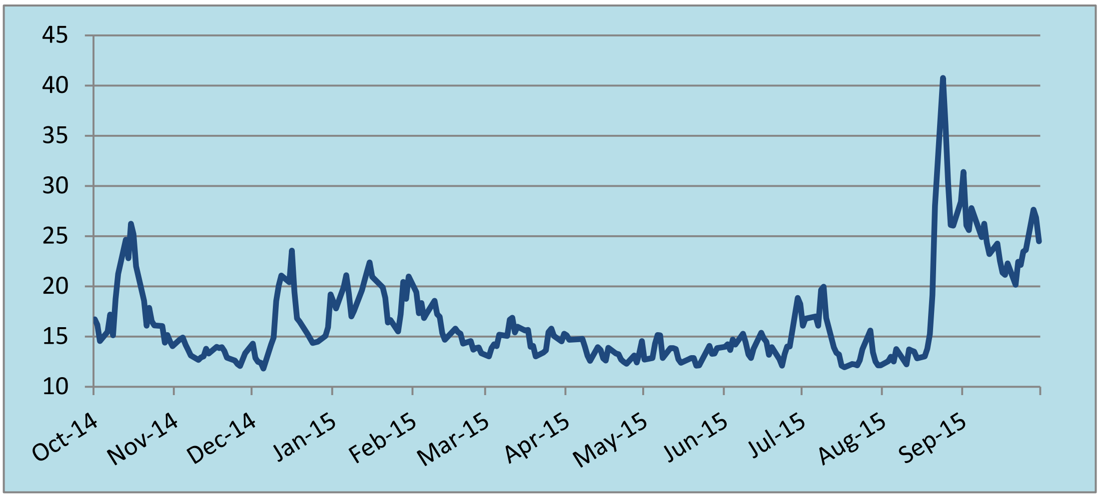
The local market started the period well, posting a strong gain in July; this was short lived however as the market then posted its worst month since the GFC in August. The market grappled with concerns emanating from emerging market economies, particularly China, which saw large scale rotations out of equities linked to the region. Investors also kept a watchful eye on the Fed and whether rates would be raised from a zero bound for the first time since 2008.

S&P/ASX 200 Accumulation Index



During the period we saw a sharp increase in volatility in global equity markets, which can be seen in the latter stages of the ASX chart above. The VIX index measures the implied volatility of S&P500 index options, which spiked dramatically in August.

VIX Index

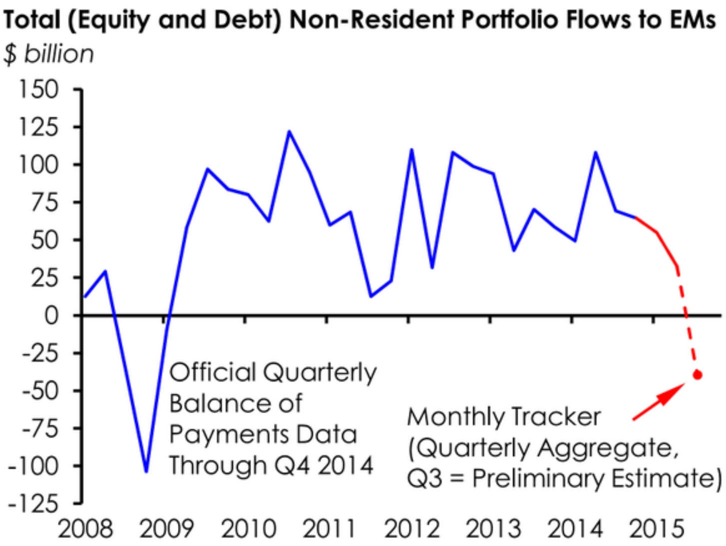


Source: Bloomberg

As expected the RBA held rates at all three meetings, keeping the target rate at the historical low of 2%. In September the Federal government saw a change in leadership after Tony Abbott was defeated in a spill by Malcolm Turnbull, who became the fifth Prime Minister in as many years. Reporting season came and went in August, but its effect on the market was benign compared to the macroeconomic events offshore.

"We have to recognise that the disruption that we see driven by technology, the volatility in change is our friend if we are agile and smart enough to take advantage of it." Malcolm Turnbull, Prime Minister of Australia, 14/09/2015

In China, the share market decline which began in June accelerated at an alarming pace. The People's Bank of China (PBoC) shocked global markets by devaluing the yuan to its lowest level against the USD since July 2012, along with a slew of other stimulus measures which we discuss in more detail later. China was not the only emerging market of concern, with the Brazilian Real falling 27% against the USD during the quarter as its credit rating was cut to junk status by S&P. Investors withdrew capital from emerging markets at the fastest rate since the GFC, as shown below.



Source: IIF

"The outlook abroad appears to have become more uncertain of late, and heightened concerns about growth in China and other emerging market economies have led to notable volatility in financial markets." Janet Yellen, Chair of the Federal Reserve Bank, 17/09/2014

The Fed decided against raising rates in September, primarily citing concerns with developments in emerging markets. Fed Chair Janet Yellen left the door open for a rate rise from near zero before the end of year; however investors are not convinced with the futures market implying only a 33% chance of a rise this calendar year. Elsewhere, Greece voted to accept an austerity package which was harsher than the package voted down in a referendum in July. In August, the Syriza party (which came to power as an anti-austerity party) won re-election with its campaign of committing to implementing the terms of the bailout program. European markets stumbled late in the quarter, after the US Environmental Protection Agency issued a notice of violation against German carmaker Volkswagen, after it was shown the company used software to deliberately mask the actual emissions levels during pollution testing.

	Sep 2015 Quarter	Year ended Sep 2015
ASX200 Accumulation Index	-6.6%	-0.7%
Best performing sectors		
Industrials	3.4%	19.6%
Utilities	2.4%	17.0%
Consumer Staples	1.5%	-9.5%
Worst performing sectors		
Energy	-24.1%	-39.5%
Materials	-10.8%	-14.2%
Financials ex Property Trusts	-9.6%	0.7%

Locally, the commodities rout drove our market lower with stocks exposed to declining materials prices being the worst hit. WTI Crude fell another 24% for the quarter, the price having now halved over the past year. Companies with financial leverage coupled with operational leverage to the oil price were hit hardest. Origin took action to reduce its debt load in September, launching a deeply discounted rights issue, whilst

Santos was heavily sold off in anticipation it would be forced to follow suit. Woodside announced a takeover bid for Oil Search, whereby Oil Search shareholders would receive 0.25 Woodside shares for each share owned. The takeover offer was ultimately rejected.

M&A was a theme throughout the market, as Asciano received a cash and scrip bid from the Canadian-based Brookfield Infrastructure Partners. Elsewhere, Affinity Education received an all scrip takeover bid from G8 Education, which was trumped by a superior cash bid by Anchorage Childcare at 92 cents. M&A continued within the Telecommunications sector as companies look to strategically position themselves before the full rollout of the NBN. After taking over Amcom in June, Vocus Communications announced it was merging with M2 Communications. TPG Telecom also completed its takeover of iiNet.

Shares of the big four banks struggled after Australian Prudential Regulatory Authority moved to quell the heat in the property market by increasing the risk weighting on home loans from 16% to 25% from July next year. The major banks also introduced lower Loan to Value Ratio caps and interest rate increases on investor property loans. We also noted during the quarter that Credit Default Swaps for the major banks reached their highest level in 2 years.

Average CDS of Major Australian Banks

Source: Bloomberg

"We run a simple company, very simple…. it does not change going forward." David Teoh, Chairman & CEO of TPG Telecom, 22/09/2015

"I think it is difficult to escape the conclusion that household balance sheets are, on average, a little more risky than they once were." Philip Lowe, Deputy Governor of the RBA, 12/08/2015

China

The weakness in the Shanghai composite which began in June persisted throughout the September quarter, as the index closed the period down 41% from its high in mid-June. The volatility in the index was remarkable with 5% intraday swings commonplace.

"Shanghai is fun to watch but it doesn't really tell you, A.) about what's going in China or B.) where the big money is." Jim Chanos, Kynikos associates, 31/08/2015

Shanghai Composite Index

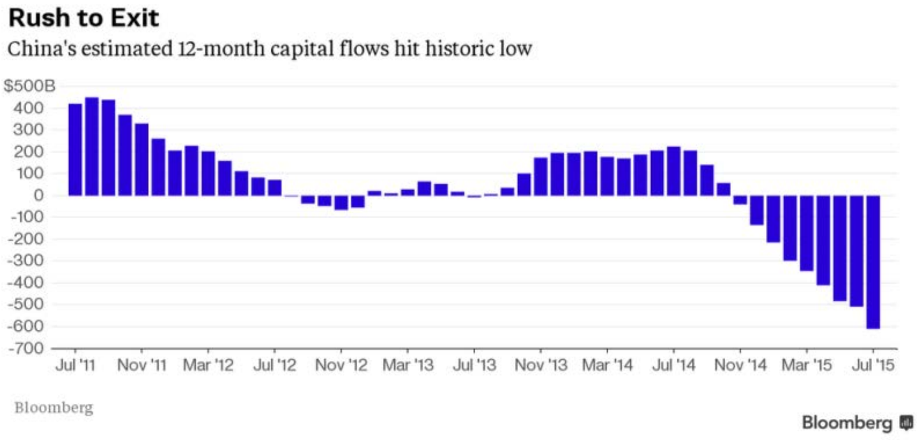
As we spoke about in the June quarterly, the central government was extremely accommodating in helping investors buy stocks. Due to the inherent risk in the market, institutions tend to steer clear of the China A-shares and choose to invest in companies listed in Hong Kong, so these measures from the Chinese government were aimed at retail investors who make up over 80% of trading in China. When the market began showing signs of faltering in June, investors all headed for the exit at once, a move which was perpetuated further by investors receiving margin calls on losing positions. The government again implemented a range of measures to help prop up the falling market, the most obvious of which was simply buying a lot of stocks. In mid-July, the government was estimated to have purchased over RMB$1.3tn worth of stock.

Other stimulus measures aimed at propping up the market included an unexpected 25 basis point cut in the bank reserve ratio, increasing pension funds limits on equity investments, and having the 21 largest brokerage houses pledge to invest RMB$19.3bn into a market stabilisation fund. Regulators prohibited company shareholders who owned more than 5% of listed companies from selling stock for six months. The government also decided to simply halt the trading of shares which were falling. At one stage in June, 26% of listed stocks on the mainland were halted at the same time. Short-sellers in the market were also banned from closing out their positions on the same day, making them vulnerable to any market reaction from stimulus announced overnight. In the search for someone to blame, authorities detained a journalist who wrote a negative article on the market. The journalist then gave a televised confession where he admitted to causing "panic and disorder" and inflicting "huge losses on the country." Eight employees from the country's largest brokerage house and two securities regulatory commission officials were also arrested in relation to the stock market rout.

Since the peak of the market in June (when the daily value traded in China was at one stage 50% higher than value traded in the US), the physical equity market value traded has fallen 70% and futures volumes have fallen 99%.

Capital Outflows

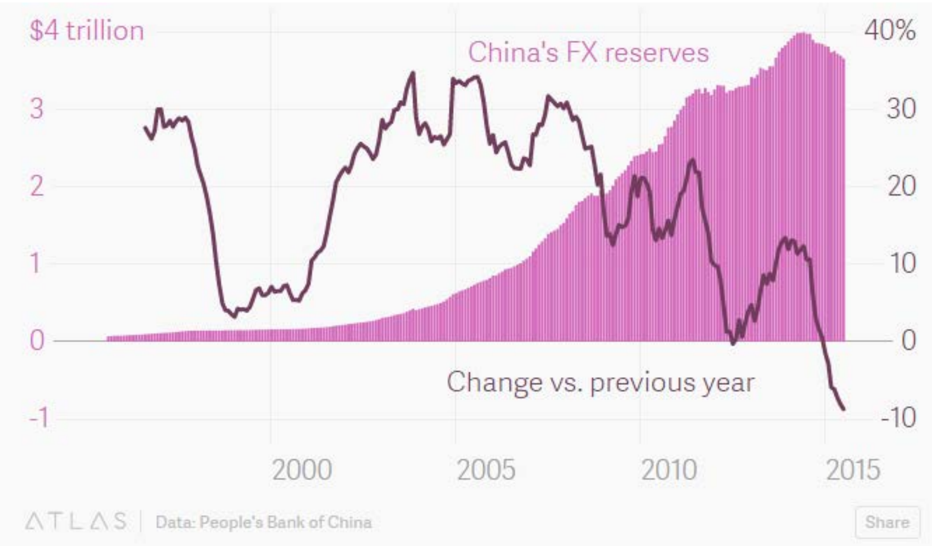
We have been monitoring capital outflows out of China for some time. Recently the magnitude of outflows has been staggering, which has caused a policy response from the government.



Source: Bloomberg

The spike in outflows was exacerbated when the central government took the unexpected measure of devaluing the yuan in August. Over the past decade when China's superior growth saw large capital inflows, the central bank amassed a large foreign currency reserve in order to keep the yuan artificially cheap. But more recently, in order to maintain the peg to the strengthening USD, the Chinese central bank has been forced to sell some of its foreign currency reserves.

"10 years ago China was a growth story, today it's a debt story.", Fraser Howie, Author, August 2015



Source: Quartz

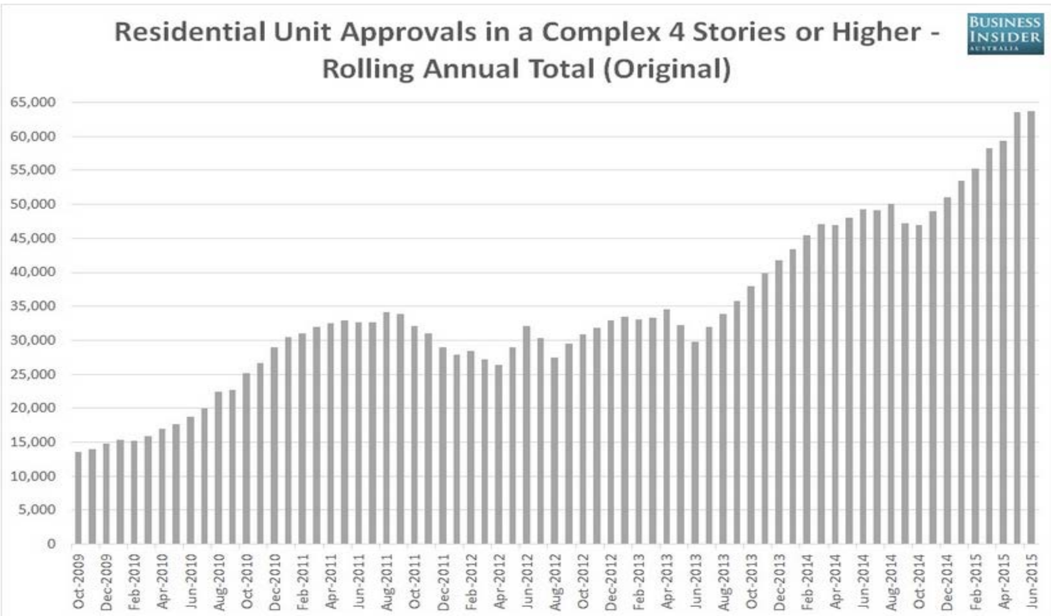
The government restricts how much money can be taken out of the country to USD$50,000 per person, per year however mainland citizens have historically found other means to expatriate their money. One of the popular methods has been through Macau. Gamblers pay junket operators in China who then make the money available to the gambler in Macau. In the past year there has been a large scale crackdown on these operators. As a result, gross gambling revenue in Macau has fallen 44% since March 2014. Macau's GDP has also plummeted; the last quarterly reading was -26% year on year growth.

Macau Year on Year GDP Growth

Source: Bloomberg

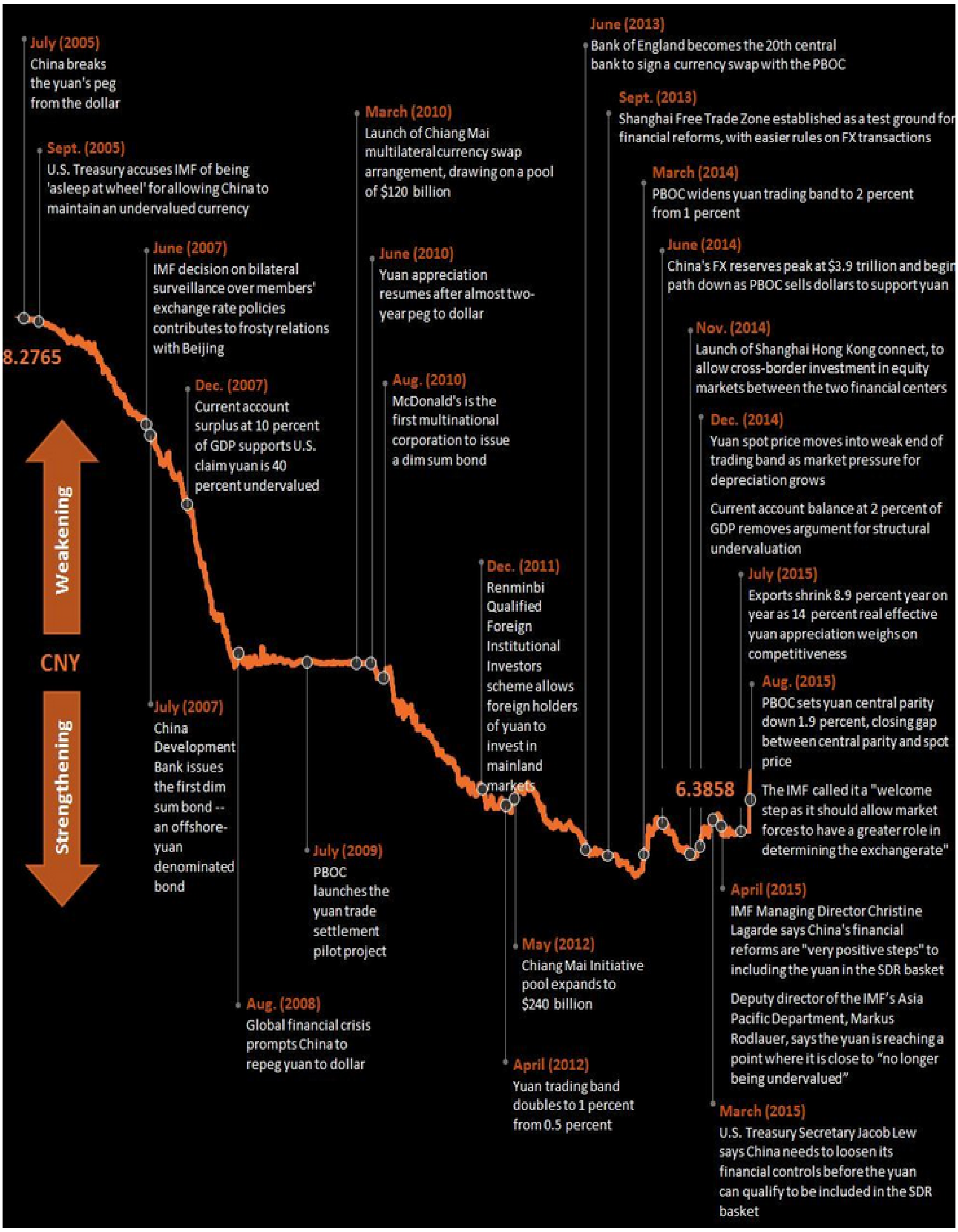
"I just sold an apartment for $15 million to somebody from China. Am I supposed to dislike them? I love China." Donald Trump, 16/06/2015

Here in Australia, aggressive bidding from foreign buyers has seen some properties sell well above their reserve. In recent weeks, we have seen the first sign of the crackdown of capital outflows having an impact on our property market. Clearance rates which peaked in July at nearly 90% for some capital cities, have now decreased to around 70%. Chinese banks have also been instructed to keep a watch on customers who engage in the practice of having a number family and friends transfer the limit of USD$50,000 to their Australian bank accounts so they can put a deposit on a property, and then paying them back in China. A Chinese property agent based in Australia was quoted as saying the crackdown has impacted "70 to 80% of current transactions". This crackdown does not bode well for the viability of the growth seen in inner-city apartment approvals.



Source:Business Insider

Here is a chart we found informative on the history of the Yuan since the peg from the USD was broken in 2005.



Costa Group

Recently, we participated in the IPO of Costa Group. Costa is Australia's largest fresh produce company operating over 3000 ha of farmland which is spread geographically across Australia's key growing regions. The group supplies major Australian supermarkets as well as wholesale markets and has the number 1 share across its four core categories being berries, mushrooms, tomatoes and citrus. Industry leading IP and their JV partner Driscolls plays a key role in sustaining the group's significant market share along with sustainability of margins.

Historical revenue growth in the past 3 years has been around 11% p.a., a multiple of the market growth rate. Future growth is underpinned by continued positive consumption trends in its main categories along with investment into initiatives such as all year supply in the berries segment. There are also some interesting international growth options which could meaningfully add to earnings on a medium to long term view.

With healthy living trends expected to remain a tailwind, we expect the demand for Australian blueberries to continue to grow at a fast pace, noting sales have increased at a rate of 20% p.a. over the last 3 years to Sept 2014. Australia's per capita consumption is less than half that of the US, so the opportunity ahead remains material. Costa is well placed to meet demand as its supply is expected to increase from both improvement in yields given their investment into protected cropping and other initiatives, along with 195 ha of absolute expansion through to FY17 (a 42% lift in capacity on a base of 465 ha).

We recently attended a tour of Costa's blueberry and tomatoes facilities in NSW, and this served to reinforce our original views that; (1) the assets are high quality and defensive in nature (2) the multi-year growth from increasing supply into the berry market has only just started (3) the Group has high quality operational management and (4) there is valuable IP beyond genetics, but also in the processes and procedures that have come about through years of experience which means it is difficult for competitors (and customers such as Coles and Woolworths) to put pressure on margins.

In Figure 1, we witnessed the tangible benefits of growing blueberries under 'tunnels'. Recently, severe hailstorms went through the Corindi region in NSW (near Coffs Harbour), and the evidence of this can be seen across the perforated coverage sheets. Importantly, the plants were all relatively unaffected compared to others in the region. Also of note is the controlled substrate (non-soil) growth environment (which is increasingly being rolled out), and when combined with the Costa's blueberry variety IP, this has led to significant step changes in yield. The plants in Figure 1 are approximately 9 months old, and will yield around 10 tonnes per hectare compared to zero if they were in soil at the same age. The following year, we should expect 14-16t, and then 20t, many multiples of what would have been expected under traditional methods.

"It is innovation that will allow businesses to access new markets, grow value and tap into global value chains to bring new products to market." Business Council Australia report, July 2014

Figure 1

We managed to sample a number of the Costa varieties, picked directly from the plants (Figure 2) and consumed in-situ, as well as in blind taste tests against other commercial varieties currently available. Whilst taste is very much a personal preference, it was clear that Costa varieties were overwhelming favoured by the group in the blind tests.

Figure 2

On balance, we expect Costa to provide solid NPAT growth over the next few years due to both the demand side (healthy eating tailwind) and supply side factors (the benefits of current investment driving yields and hence returns higher). We recognise that some agricultural risks remain, and that some of the key sites are not owned (but rather leased on a long term basis), so this does feed into our view on valuation.

Overseas Trips

This quarter we travelled to the US twice and to the UK.

U.S. Media

Share prices of U.S listed cable networks have come under pressure recently, due to perceived structural vulnerability stemming from the entry of Over the Top (OTT) content providers such as Netflix and Hulu. We attended a media conference in New York to gain a more thorough understanding of the current industry dynamics.

- Advertising markets are better than expected and more follow through is expected as political spend steps up. Overall the environment appears solid, and pacing up across consistent feedback from all advertising agency buyers and content owners.
- There is a notably stronger and more coordinated view around how to deal with OTT, with a trend towards content costs being tied to subscriber numbers. There is a real acceptance that OTT is here to stay, and given it is a model that certain consumers want, content providers are more focused than ever around how they get paid for it.
- The industry's understanding of digital advertising has improved. The pace of change here has been positive, with the industry putting in place both the technology, and people to deliver ad content digitally to the point where networks see digital advertising growth offsetting the declines from its linear general entertainment ratings weakness.

"When was the last time anybody saw us beating, let's say, China in a trade deal? They kill us. I beat China all the time. All the time." Donald Trump, 16/06/2015

U.S. Macro observations

- The US economy feels as good as it has since we have been visiting post GFC. Still only 2-3% growth but getting less comments/anecdotes on the reasons why it is patchy or not going to improve. Brambles still confident that the retail/FMCG industry inventory restock should lead to better volumes in 2016.

- Housing starts continue to trend up towards the long-term average of 1.5 million starts, with growth forecasts for 2016 from various market forecasters ranging from 4% to 14% growth. Labour shortages is the biggest constraint to housing starts growth, with labour shortages today equivalent to labour shortages when the US was at previous peaks due to a reduction in immigrant workers and retired workers not being replaced by the younger generation.

- The Texas economy hasn't felt the same flow-on effect of a large decline in the oil price as it did during the similar down cycle in the 1980's. The economy has diversified significantly since the 1980's; in 1981 oil and gas extraction accounted for 19% of Texas GDP whereas today it only accounts for 14%. Back in the 1980's, 1 out of every 7 workers in Houston lost their job. Anecdotally on this visit to Houston, this statistic was significantly less. The other important factor is that the larger downstream industry today (petrochemicals, refineries, LNG facilities etc.) are actually a net beneficiary of lower oil prices.

"Small businesses create more than 60 percent of new American jobs on net, so they have to be a top priority. I've said I want to be the small-business president, and I mean it." Hillary Clinton, 12/07/2015

Outlook

Concerns around capital flows from China remain whilst two additional concerns emerged.

Whilst we are still buoyed by our observations in the U.S, we did note that the strong USD is impacting growth, which was evidenced by the weaker than expected payrolls number and some large negative revisions of earlier months. The other emerging concern is the fall out in Europe from the VW emissions scandal. Germany has been a core contributor to baseline stable (albeit very slow) growth for the last few years. The recent scandal, with unquantifiable costs, is observed to be weighing on German consumer confidence.

With these additional areas of concern emerging this quarter, Greencape have been careful not to fully deploy our higher than usual cash position into the equities market pullback. The weaker delta in US growth implies rate hikes will be delayed (and at least tempered) so we remain conscious of another rotation to yield within markets. We think these volatile times create opportunities for competent management teams who have access to balance sheet latency. Strong balance sheets have become more valuable in our view, with this being reflected in our stock picking. We are comfortable with our portfolios reflecting bottom up quality yet more conservative capital structures given some emerging macro concerns.

"It's easy for investors to get into trouble if they fail to understand the difference between cheapness and value." Howard Marks, Chairman of Oaktree Capital, 09/09/2015

More information

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