CI AUSTRALIAN EQUITIES FUND
QUARTERLY COMMENTARY REPORT

Cooper Investors Pty Limited | AFS Licence Number 221794 | ABN 26 100 409 890

For current performance information please refer to the Monthly Performance Report.

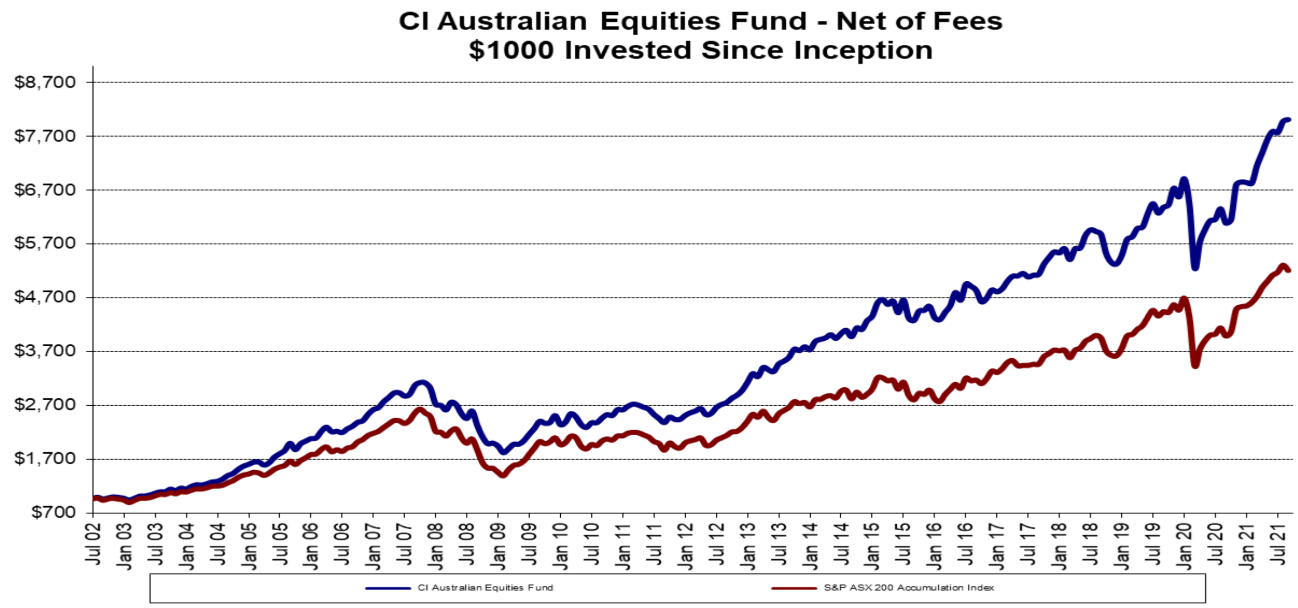
SEPTEMBER 2021

***"The person who turns over the most rocks wins the game."* Peter Lynch**

***"The single greatest edge an investor can have is a long-term orientation."* Seth Klarman**

	****PORTFOLIO**	**#BENCHMARK**	**VALUE ADDED**
ROLLING 3 MONTH	3.03%	1.71%	1.32%
ROLLING 1 YEAR	32.63%	30.56%	2.07%
ROLLING 3 YEAR	11.74%	9.65%	2.09%
ROLLING 5 YEAR	11.52%	10.42%	1.10%
ROLLING 7 YEAR	11.63%	9.14%	2.49%
ROLLING 10 YEAR	14.03%	10.80%	3.23%
SINCE INCEPTION*	12.55%	8.95%	3.60%
SINCE INCEPTION^	873.49%	420.41%	453.08%

*Annualised
^Cumulative (4 July 2002)
**Before fees and expenses
#S&P ASX 200 Accumulation Index
Past performance is not necessarily a reliable indicator of future performance



Source: NAB Asset Servicing

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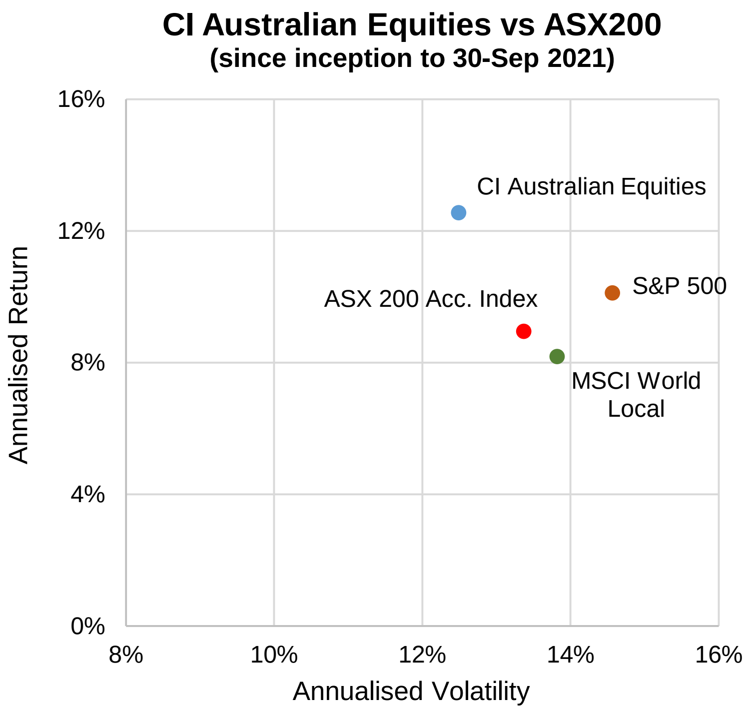

Market and Portfolio Performance

The ASX200 Accumulation Index rose 1.7% over the quarter, despite falling 1.8% during the month of September – remarkably the first negative month for the market since September 2020. Stronger contributors to portfolio performance over the quarter included Macquarie Group (positive operational update during the quarter), Computershare (rising bond yields would have a positive medium term effect on earnings) and Aristocrat (ongoing positive momentum in the business). The stocks whose performance over the period disappointed included Reece (pulling back from an overbought position, most likely due to its inclusion in the ASX100 index), Northern Star (static gold price and sector underperformance) and Bluescope Steel (steel spreads, particularly in the USA, reaching levels which are likely to be unsustainable in the medium term especially in light of competitor capacity addition announcements).

Energy (7.6% outperformance) and Industrials (4.9%) were the top sectors. On the flipside, Materials underperformed by a substantial 11.6%. The key driver of this sharp decline was a collapse in the iron ore price, which fell 44% to under $120/tonne. This reflects a number of factors, including: i) recovering supply from Brazil; ii) a slowdown in property activity in China; iii) escalating concerns around the solvency of China's second largest property developer, Evergrande; iv) a crackdown on steel production given environmental concerns; and v) no doubt, an unwind of speculative fervour when the iron ore price was over $200/tonne. Unsurprisingly, this led to large sell-offs in the likes of BHP, Rio Tinto and Fortescue. While this is clearly a weakening of significant magnitude, it is worth noting that the price has simply retraced to where it was one year ago and is still a long way above the cost of production.

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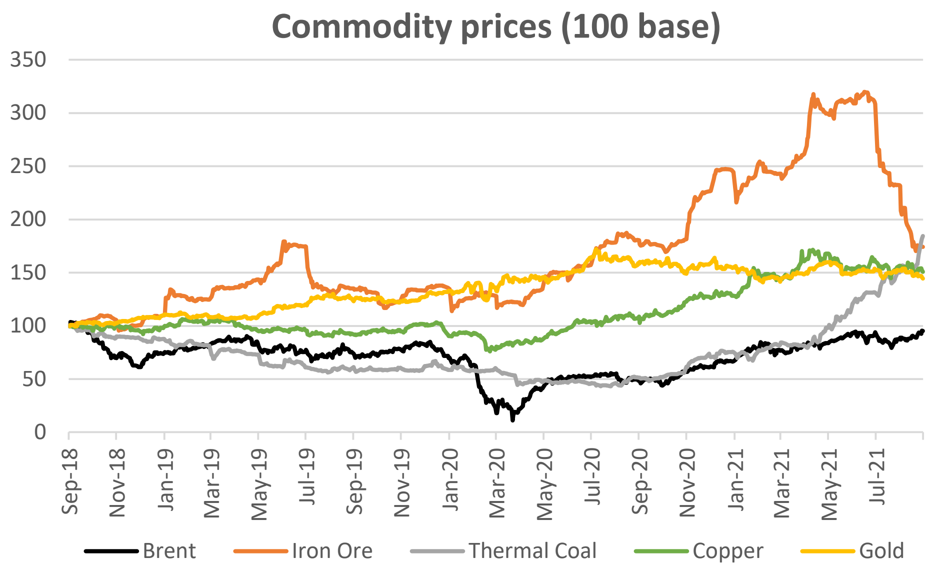
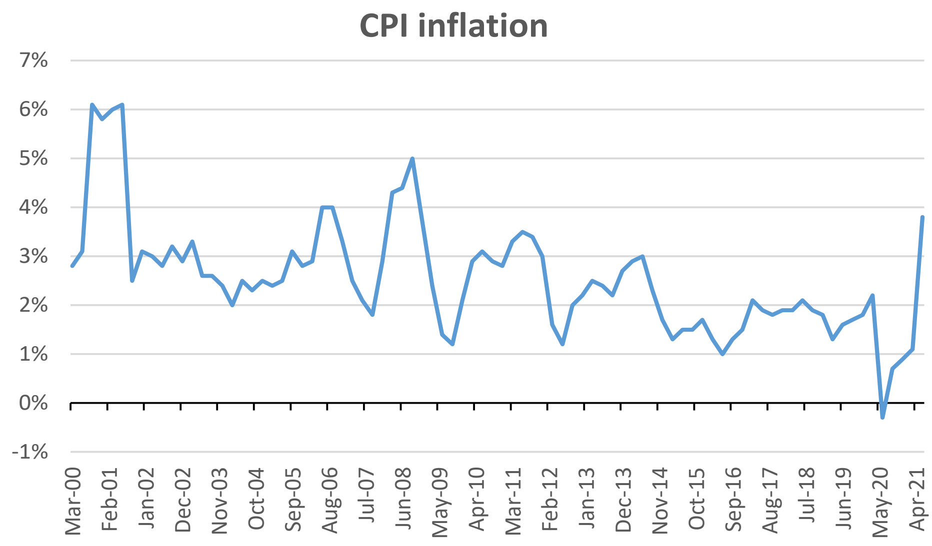


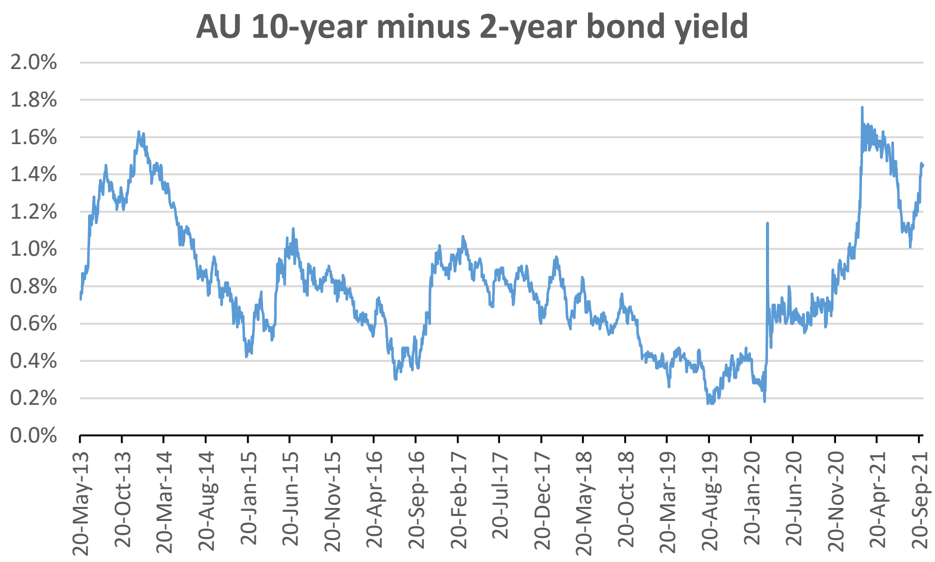
Source: FactSet

Reporting season in August saw generally solid results, albeit this was overshadowed by an increasingly uncertain outlook as the COVID Delta strain hit NSW and then Melbourne. This caused most management teams to provide cautious guidance, or none at all, and analysts to downgrade forecasts. Notwithstanding, the market appeared willing to look through this uncertainty. This likely reflects a combination of COVID fatigue and confidence that rapidly rising vaccination rates would soon benefit so-called reopening plays.

Both the US Federal Reserve and the Bank of England conveyed an increasingly hawkish tone during the quarter, which resulted in bond yields rising. While the RBA's language remains dovish, the prospect of higher interest rates offshore and evidence of rising inflation domestically resulted in the yield curve steepening again.

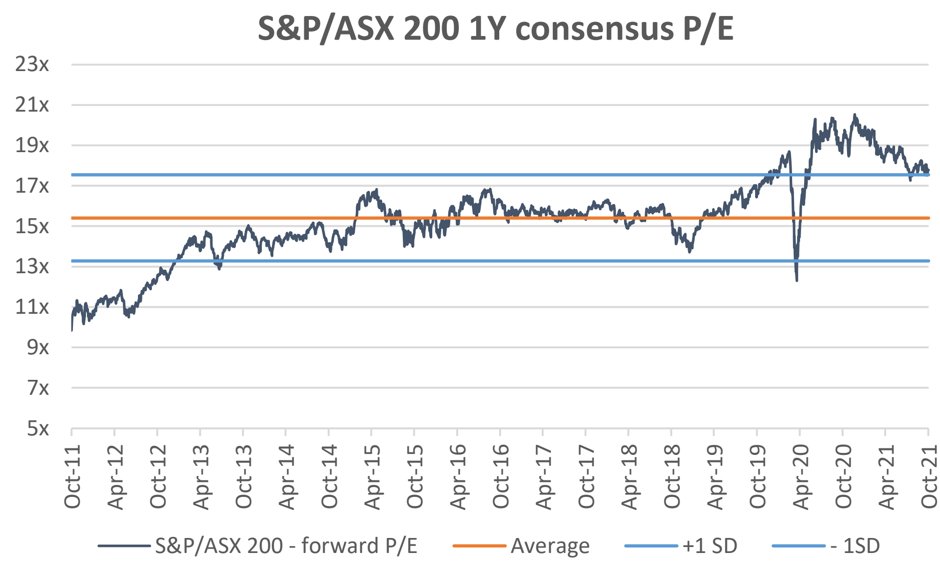


Source: ABS



Source: RBA

Unsurprisingly, the steepening has coincided with a contracting market multiple.

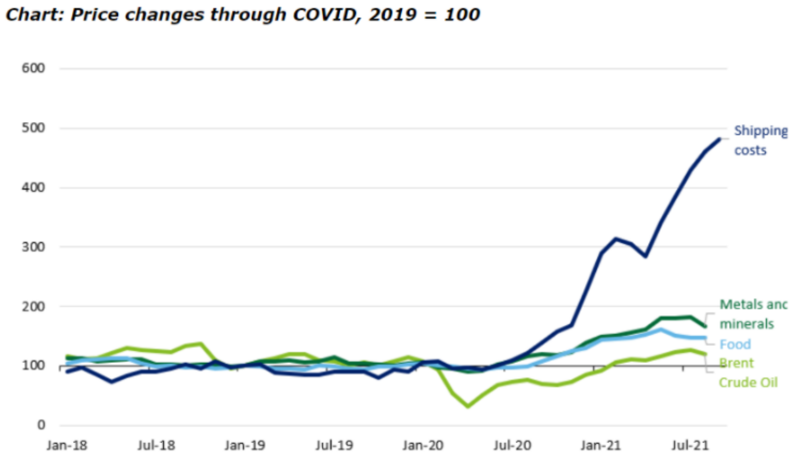


Source: FactSet

Notwithstanding the multiple moderation, it remains high by historical standards. This likely reflects a combination of low (but rising) bond yields, still generally buoyant sentiment and significant liquidity. Central banks face some difficult choices in the months ahead. On the one hand a normalisation of the global economy on the back of rising western world vaccination rates and re-openings might lead one to believe that current historically low interest rate settings may finally start to move sustainably higher. The flipside to this argument is the amount of indebtedness globally across various sectors of the economy today and the impact that even a relatively small move in interest rates may have.

On top of this conundrum there are a number of other unusual events occurring at the same time which companies are having to face:

- Surging energy prices as the prices of gas, oil and coal rise – leading to power rationing in China and bankruptcies of suppliers and other disruption in the UK
- At the same time as prices are rising, production of these commodities is (and will likely remain) under pressure due to growing environmental concerns
- Pressure across the global trade and transport network has seen ongoing increases in shipping costs which continues to feed its way through global supply chains:



Source: OECD, via Macrobusiness

- A number of companies we have had contact with recently have spoken to difficulty in accessing sufficient suitable labour due either to covid or other reasons. It seems likely labour, as well as other costs, will continue to rise as demand improves with global re-awakening from covid shut downs
- Geopolitical tensions are rising between the world's two major powers China and the USA

Although we have to operate with a backdrop of diverse events, rather than trying to predict macro outcomes, which are a complex interplay between economic, political, regulatory and social factors, we remain focussed on identifying stocks with attractive risk-adjusted value latency. We are looking for companies with opportunity to create value for shareholders over the medium term, and management teams with the capability AND intentionality to achieve this goal.

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The Portfolio

We recently initiated a position in **Star Entertainment (SGR)** after the stock had underperformed on the back of COVID-related venue closures. We consider Star to be a high-quality stalwart that offers latency from both post-COVID cyclical reversion and multiple opportunities for additional value creation. Both domestic and international experience has shown that casino activity rebounds quickly once restrictions ease. Above and beyond this, we see a highly capable management team that has a clear focus on realising value from: i) negotiating an extra 1,000 electronic gaming machines in Sydney; ii) additional capacity and monetisation opportunities when Queen's Wharf Brisbane opens in 2023; iii) the option to unlock proceeds by selling and leasing back properties; and iv) the prospect of industry consolidation. Star benefits from having ultra-long-dated licenses in attractive locations and hard-to-replicate assets with high barriers to entry. With capital expenditure and equity contribution commitments now substantially complete, it looks set to enter a sustained period of high free cash flow generation, which should support rapid balance sheet de-gearing.

After outperforming the market by a sizable 29% in the seven weeks since the FY21 result, the stock fell sharply this week following media allegations of inadequate anti-money laundering processes. The pullback was larger than Crown initially experienced following similar allegations in 2019. This can likely be explained by: i) concerns that this could derail the various value creation opportunities; ii) the accusations bringing into question the widely-held view that Star has superior risk management and governance than Crown, causing the valuation premium to deflate; and iii) fears that this could bring similar regulatory scrutiny to that experienced by Crown in subsequent years, with loss of licence a potential worst-case outcome.

Our initial impression is that the extent of the reaction is overdone. The issues raised appear more specific than systemic, often relate to historical matters that have since been rectified and are narrower than the matters faced by Crown (i.e. Crown is also dealing with tax underpayments, weak corporate governance and accusations of threatening behaviour). However, we will continue to monitor developments closely to understand the implications. This includes the looming release of Hon. Ray Finkelstein's findings from the Royal Commission into Crown Melbourne's suitability to hold a casino licence.

We also initiated a holding in **Qantas (QAN),** which is a well-managed and iconic brand that will benefit from both late-cycle reversion and an underappreciated self-help story. COVID-related travel restrictions have cast a long shadow over the stock in the last 18 months. However, the light at the end of the tunnel is growing brighter with capacity guidance now tied to the Government's vaccination program rollout. Similar to casinos, experience has shown that demand rebounds quickly once restrictions are eased. Although further lockdowns cannot be ruled out, more widespread vaccinations should make them more limited in future. While COVID took a heavy toll on operating trends, it has likely improved industry structure and Qantas' strategic positioning. Private ownership of Virgin is likely to create a more rational environment for Qantas Domestic, Tiger's exit further strengthens Jetstar's dominance in low-cost travel and International should benefit from global peers' balance sheet stress and more careful approach to route selection. Loyalty is an outstanding business with distinct competitive advantages (e.g. first-mover, high switching costs, deep and broadening customer value proposition). The group is run by a highly experienced and focussed management team, which has responded dynamically to COVID. This includes pursuing an ambitious Recovery Plan, which includes a $1bn structural cost-out that the market is seemingly not giving it full credit for.

Reece (REH), Australia's largest distributor of plumbing and bathroom materials, reported a solid FY21 result in the face of a disruptive supply chain environment. Management's prudent investment in inventory early on in the pandemic put them in a strong position to service elevated demand across both the ANZ and US housing markets (revenue +9% and +9.5% respectively).

Our long term investment thesis centres on REH's US growth strategy which was accelerated by the $1.9 bn acquisition of US-based Morsco in 2018 (170 stores across the "Sun Belt" region). Unlike Australia, the US plumbing market remains highly fragmented with the top 5 players accounting for just c. 30% of the market.

Overseas expansion is not without risk. However the potential for success is strengthened by the presence of a highly capable, founder led management team with an exceptional track record in the Australian market. Under the leadership of the Wilson family, REH's domestic success has been driven by a combination of organic store roll-out, accretive acquisition of smaller plumbing groups, and considerable investment in inventory, supply chain and technology relative to peers. The associated benefits of scale have driven margin accretion to industry leading levels.

Over the past 18 months management have patiently tested a number of store formats in the US market and seem quietly confident they are getting closer to a model they are comfortable with. We are pleased to see management flag a significant step up in operating and capital expenditure in pursuit of the US roll-out opportunity.

During the quarter, **Lendlease (LLC)** held their annual strategy day, the first under new Group CEO Tony Lombardo. Pleasingly, the strategy day highlighted two developments that are supportive of our investment proposition. Firstly, a significant accounting change relating to capital partner transactions that, in addition to the announcement ~12 months ago that property investment revaluations will be taken below the line, will see accounting profits closely aligned with cash profits moving forward. We see this accounting change as being a positive sign of the trends in focussed management behaviour not only because of the improved earning quality, but also because it was implemented despite the negative impact to accounting profit and returns the change has on near term earnings. Secondly, confirmation that development projects put into delivery over the course of the last 12-18 months underpin ~$7bn of production and a return to mid cycle returns in FY24. Combined with multi-family rents in the majority of LLC's US markets now coming back to or above pre COVID levels and signs of a similar recovery taking place in London, there are positive signs operating trends are beginning to move off the bottom of the cycle. We remain focussed on the repeated observation of these trends.

In September **Santos (STO)** announced it had entered into a definitive agreement to merge with Oil Search (OSH) in an all scrip transaction that would see STO shareholders own ~61.5% and OSH shareholders 38.5% in the merger entity. STO expect the merger to unlock pre-tax synergies of US90-115m p.a and have a strong track record of integrating previous acquisitions, exceeding initial synergy estimates in both the acquisition of Quadrant Energy and Conoco Phillips Northern Territory assets. In our view, the combination of STO and OSH unlocks value in PNG by facilitating the alignment of ownership between PNG LNG and Paupa LNG, creates a highly free cash flow generative business with a pipeline of growth projects extending out for the duration of this decade and a balance sheet in strong shape (particularly post likely sell downs in PNG and Alaska) extremely well placed to execute. The OSH Board has unanimously recommended their shareholders vote in favour of the transaction with an implementation date targeted for mid-December.

In conjunction with their half yearly results, **Ampol (ALD)** announced it has submitted a non-binding indicative proposal to acquire Z Energy (NZ$2.8bn). On one hand we view the acquisition as potentially opportunistic, acquiring a highly free cash flow generative business whose returns are currently depressed relative to history with clear and relatively low hanging synergies in the form of removal of duplicate corporate costs, fuel supply and retail network optimisation opportunities. On the other hand, the alternative which we see as a material share buy-back whilst both ALD's returns and share price are depressed that would also distribute a portion of the ~$650m of surplus franking credit balance back to shareholders as an attractive, low risk latency opportunity. As such, we seek to better understand from management the extent of the opportunity they see to create value (not just EPS accretion in a largely debt funded deal) through the potential acquisition once due diligence is complete.

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Brambles (BXB), was another company that held an investor day during the quarter, their first since 2018. The focus was very much on ~US$450-500m of investment over the next 24 months into the digitalisation of the pallet pool and further automation of service centres to drive improved free cash flow generation and high single digit earnings growth (vs the mid-single digit CAGR BXB has delivered over the past ~20 years). The service automation is very much in BXB's wheelhouse and a natural progression of the successful program they have recently completed in the US. Whilst small and targeted pallet digitilisation trials have been successful, wide scale tracking is still very much in proof of concept phase with further trials over the next 12 months to test the concept at larger scale. Ultimately, if successful BXB utilising tracking technology will be an example of an old age company taking advantage of a privileged competitive position and using technology to materially improve the core business. Conceptually, the opportunity here is significant with BXB spending an average of US$650m p.a over the last 5 years replacing lost pallets. If through digitalisation of the pallet pool, BXB is able to halve the current loss rates, this would free up ~US$325m in cash flow p.a, more than doubling the free cash flow the business has generated historically.

The stock fell 10% post the above mentioned strategy day due, we believe, to a number of factors including greater opex and capex over the next two years than anticipated, a resultant lower trajectory in earnings growth, and nervousness over the outcome of the plastic pallet trial currently underway with Costco (seen as likely to dilute returns once the trial is taken into full production in 2023 and beyond). We believe, based on the success to date of similar initiatives, management will achieve its required return on the automation project, and the the digital spend is necessary and will be gated to ensure minimal unnecessary expense. We await with interest the results of the Costco plastic pallet trial – it seems inevitable BXB will have to proceed further in order not to lose its market leading position so the real question will be the the rate of return the company can earn on a closed loop plastic pallet pool.