BLACKMORE CAPITAL
EQUITY INVESTORS

Australian Equities Income Portfolio

Q3 FY18 Quarterly Investor Letter | March 2018

Performance and Investment Review

The Australian Income Portfolio commenced investing in May 2014. Since its inception, the portfolio has achieved a compound annual return of 9.51% compared to the ASX 200 Accumulation Index of 6.01%; this represents an excess return of 3.50%.

For Q3 FY18, the portfolio was down 1.53% compared to the ASX 200 Accumulation Index which was down 3.86%. For Q3 FY18, the major positive contributors to the investment performance were Washington H Soul Pattinson (SOL), Coca-Cola Amatil (CCL), Brambles (BXB) and Insurance Australia Group (IAG). The main detractors to performance were Qube Holdings (QUB), Viva Energy (VVR), and CYBG PLC (CYB).

The Australian equity market experienced its worst quarter since September 2015 as almost all sectors were down from February, instigated by the prospect of higher global interest rates and geopolitical concerns around deteriorating relations between the United States and China on trade-related issues. It was a timely reminder that equity markets are subject to periods of heightened volatility and turbulence, especially when asset valuations are at historically high levels. A core objective of our investment process is that our portfolios exhibit greater resilience in periods of equity market duress.

With the Australian equity market reaching its most recent peak on the 2nd February, the ASX 200 Accumulation has subsequently fallen 4.26%. Over the same period, the Australian Income portfolio fell 1.76%, capturing only 41% of the market drawdown. In recent months, we have consciously tilted the portfolio toward an increased focus on value and raising cash levels.

Central to our investment process is that we remain, unequivocally, focused on investing for the medium to long-term. We place little emphasis reading into the significance of daily movements in financial markets. Rather, we find it economically and intellectually more robust to observe longer durations of data to distil an understanding of investment fundamentals, which underpins our inferences on value and risk.

Investment Performance since Inception (%)

Source: Praemium Ltd

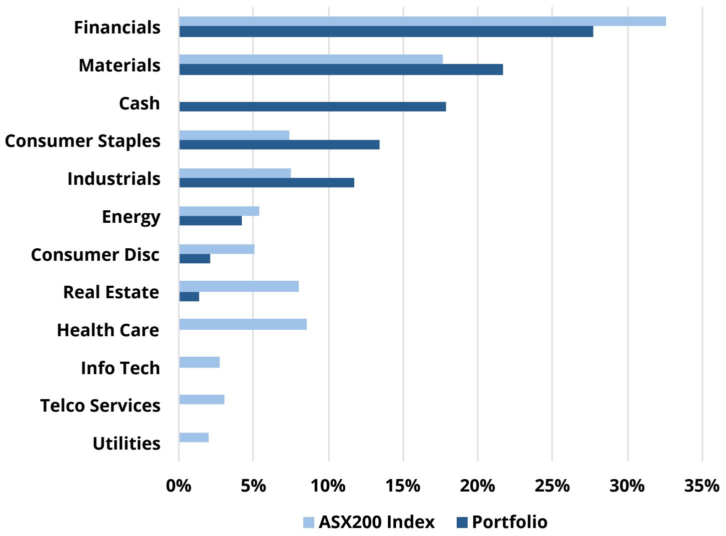
Performance Table

Historical Return	Blended Australian Equities	ASX 200 Accumulation	Relative
Financial Year 2015	13.6%	5.7%	7.9%
Financial Year 2016	7.7%	0.6%	7.1%
Financial Year 2017	10.5%	14.1%	-3.6%
Financial Year 2018	4.4%	4.2%	0.2%
Since Inception (p. a)	9.5%	6.0%	3.5%
Risk Adjusted Return	0.8	0.4	0.4
Dividend Yield^	5.7%		

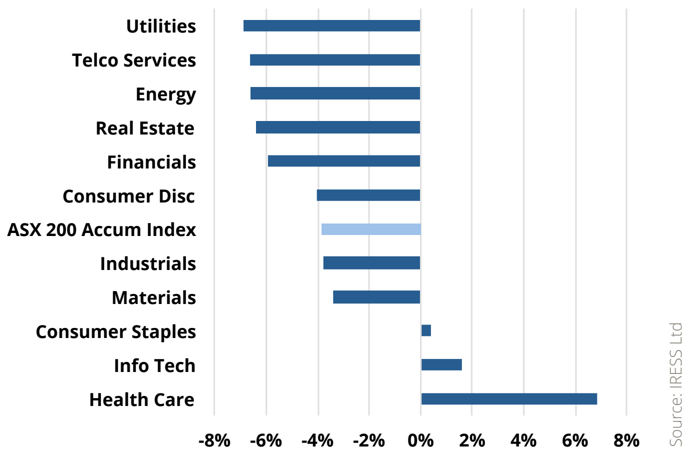
Source: Bloomberg & Praemium Ltd

Figures shown are before fees and inclusive of franking credits.^ Gross yield including franking credits for the previous 12 months.
Past performance is not an indication of future performance

Relative sector weights - March 2018



Sector returns - Q3 FY18



> "I believe that many people underestimate the possibility of higher inflation and wages, which means they might be underestimating the chance that the Federal Reserve may have to raise rates faster than we think."
>
> Jamie Dimon, CEO of JPMorgan Chase

Company & Industry Analysis

Our investment process blends both qualitative and quantitative analysis at a company and portfolio level. A core part of our qualitative investment process involves undertaking an active company and industry visitation program. Company investor briefings and one-on-one meetings with senior management provide an invaluable source of detailed knowledge that underpins our investment due diligence. During Q3 FY18, a notable highlight was visiting a range of companies and industry participants in the UK, including:

- **Banking, Asset Management and Property:** Blackrock, CYBG Plc, Macquarie Group and Virgin Money;
- **Logistics and Supply Chain:** Ahma Pooling, Brambles, EPAL, RM2, Pladis Global, Peco Pallets;
- **Supermarkets:** Asda, Ocado, Sainsbury;
- **Media:** News Corporation;
- **Renewable Energy:** Green Investment Bank (Macquarie);
- **Resources:** Anglo America and Blackrock Resources Fund;
- **Technology:** Xero

Over the course of eight days, we held discussions with over 35 companies and attended the Brambles Investor Day. We primarily held the meetings with Company Chief Executives, Chief Financial Officers, General Managers, and non-executive Directors. We also met with several industry consultants across the logistics, supermarkets and technology sectors. A range of valuable insights and observations were gleaned, summarised as follows:

- Global synchronised economic growth is leading to inflationary pressures building across supply chains. Cost pressures are emerging in labour and its availability, energy prices, lumber and acute shortages arising in the transportation industry.
- As investors, we need to pay increasing attention to the risks associated with rising inflation and interest rates;
- Automation, digitalisation and artificial intelligence are becoming an integral part of banking, supply chains and the resource sectors;
- Renewable energy/sustainability/social licence to operate – has become a significant part of every company's right to operate. Recyclability, reusable materials and the circular economy persuasive in every company discussion.

Company & Industry Analysis

Banking (CYBG Plc, Macquarie & Virgin Money)

- The UK economy has outperformed our expectations since Brexit (Virgin Money). There has been no major pause in activity.
- Employment remains stable, and impairments remain benign, no pick up in loss ratios.
- Average weekly earnings over the three months to January grew 2.8% compared to one year earlier, the highest increase in three years. Moreover, the rate of unemployment reached its lowest since 1975.
- New regulations on stamp duty and tax incentives have dampened Buy to Let market. Margins are compressing, yet, UK housing market remains deeply undersupplied.
- However, the persistence of debt remains an issue for the consumer. Unsecured credit debt for UK consumer is 27% of household earnings.
- Digitalisation is removing the need for branch network as more consumers shift to online banking. Big banks in the UK continue to face challenges of multiple legacy systems. Challenger banks more dynamically positioned for digital banking, specifically CYBG Plc.

Logistics & Supply Chain Management (Brambles & Supermarkets)

- Brambles, through its CHEP (Pallets) and IFCO (Containers) businesses, play a critical role throughout the entire logistics supply chain. CHEP and IFCO play essential parts in First Mile Solutions (raw materials to Manufacturer/Producer) to Last Mile Solutions – (Manufacturer/Producer to distribution centre-retail store/consumer)
- Industry cost pressures are present and building.
- Today inflation is a much higher risk.
- Higher lumber, labour and transport inflation is evident across the Americas, Europe and Asia Pacific.
- In North America inflationary pressure has increased notably over the last 12 months, namely: Labour +3.0%; Lumber +9.0%; Transport +6.2%; Oil (Crude) +11.4%; and Fuel (Diesel) +14.7% (source Brambles investor briefing).
- Fast moving goods companies, logistics companies and retailers grappling to absorb cost increases.
- Traditional retailers are being squeezed from all directions.
- Grocery retailers' main pressure is from the discounters rather than online competitors. In turn, retailers are putting pressure on manufacturers.
- Discounters products are heavily skewed to house brands – seeing brand equity degrading.
- Proctor and Gamble is taking out another round of cost reductions as slower sales growth and rising inflation places pressure on margins.
- Online grocery sales are slowing in the UK, and Walmart (US) reported online sales growth slowed in its most recent quarter.
- The grocery sector is the largest component of the retail sector, but ironically it has the lowest online penetration. Grocery is a far more complex business to bring online given that the number of goods sold per transaction is substantially higher 45-50 products compared to an average online transaction on Amazon of 1.8 goods sold per transaction; and, grocery delivery requires three types of temperature control: ambient, chilled and frozen. The cost to serve, therefore, is materially more for online grocery.
- Interestingly, for the grocery discounters (10% market share and growing) online investment is not a priority. Physical store locations remain a key competitive threat.
- With the persistence of inflationary pressures, CHEP is attempting to rewrite new contracts (one-third of contracts come up for renewal annually) to provide better protection to rising input prices (labour, lumber and transport). CHEP expect cost pressures will persist.
- As a market leader, CHEP is keeping prices flat in a bid to put pressure on smaller competitors who are also struggling with cost pressure.
- CHEP has the most extensive pallet pooling network in Europe and the USA. CHEP's European business, where it has 115 million pallets in circulation with 315,000 delivery points compared to its nearest competitor of 18 million pallets and 23,000 delivery points, highlights its market dominance. In the US CHEP has 100m pallets and serves 45 of the top 50 FMCG manufacturers.
- Increasing automation by CHEP is a key competitive advantage over its smaller rivals.
- BXB Digital – established two years ago to fast-track supply chain information technology into Brambles' offering. BXB digital is developing real-time data on supply chain logistics. Brambles has first mover advantage in its investment in data analytics compared to its competitor base. With the use of data analytics (tracking technology), Brambles should be able to embed itself deeper into its customer supply chain.
- The next major sector to adopt robotics and Internet of Things is the logistics industry as the continued growth of e-commerce is putting material pressure on material-handling costs.
- There is growing evidence of the use of robotics in warehouses and distribution centres. Europe is a leader in warehouse automation, driven by high fixed costs in labour.
- Recent technological advances in the Internet of Things and robotics ensure that this cadence is accelerating. The fusion of the Internet of Things and robotics will drive a step change in productivity. Brambles is undertaking a big step change in the conversion of technology to create a "smart" pallet.
- Digitisation enables retail supply chains and just-in-time delivery, as well as online capability.
- Robotic process automation (software programs to automate mundane tasks). The market for robotic process automation is expected to grow to $US2.9 billion by 2021, up from $US250 million in 2016.
- CHEP is addressing the operating challenges of inflationary pressures with increased plant automation. With only 20% of plant automation in the USA (compared to 80% in Europe), there is a long runway for improvement to be executed over the forecast period.
- CHEP USA has committed US$150-$160m capital investment in automation from FY19-FY21, with a four-year payback. Automation will increase network capacity by 30%.
- At the plant level, automated solutions will address automated pallet inspection; automated repair and robotic sort of stacking of pallets. Greater plant automation should lead to better capital efficiency and cycle times improving.
- Brambles expect that margins will improve in 2H18. A key risk is rising inflation and cost pressure.
- Brambles maintained medium-term targets of mid-single digit revenue growth. Revenue growth is broken down into CHEP Americas 3-5%; CHEP EMEA 4-7%, CHEP Asia-Pacific 2-3% and IFCO 7-10%. Average weighted revenue growth of 5.4%.
- IFCO US business is under review given low return on capital.
- Brambles' business modus operandi fits the new world requirement by reusing assets in a pooling system.

Company & Industry Analysis

Global Infrastructure and Renewable Energy
(Macquarie Group)

- Governments in Europe are very supportive of renewable energy, leading the world in its development.
- Global mega-trend is decarbonisation; rotating existing fleet from high carbon to low carbon technology. The runway is 10 to 20 years.
- The cost of renewable energy is reducing dramatically, providing support for a reduction in subsidies. Momentum for "subsidy-free" renewable energy is growing. Today, the subsidy in wind farms is virtually zero in Germany and the Netherlands.
- Macquarie have invested in 40% of all megawatts from UK offshore wind farms.
- Despite the continual improvement in technology and cost of renewables, there is still a requirement for base load energy supplied by gas, nuclear and/or batteries.
- **UK Energy/Renewables** – CO2 emissions have declined faster in the UK since the early 1990's than in almost any large economy.
- The UK has shifted away from coal (7% of power generation, which compares to 40% in 2012). Target to phase out coal-fired power stations by 2025.
- Renewable energy sources account for 29% of UK electricity generation (wind, solar and biomass), backed by gas and nuclear generation.
- UK emissions are 38% below their level in 1990.
- Carbon dioxide emissions (CO2) increased by 1.4% driven by China and India's demand for energy. By contrast, the US, Europe, Mexico and Japan all saw a drop- in emissions. The biggest drop in emissions was the US where emissions fell by 0.5% to 4810m tonnes of CO2, the third consecutive year of decline.
- In 2017, renewable energy has achieved the highest growth rate of any energy source, according to the International Energy Agency.
- Old world energy – Utility and Petroleum Companies are stepping into renewable energy to gain efficiencies in existing businesses and developing new revenue streams.

Resources Sector
(Anglo America, Blackrock Resources Fund)

- To date, 18 months of synchronised global economic growth. Expectation that global growth will remain relatively supportive for next 18 months to two years.
- Reform agenda around environmental sustainability in China is long-term in nature and structural. There has been a withdrawal in the supply of low-quality commodities from China; this is supportive of demand for higher quality commodities – beneficiaries Alumina, BHP and Rio.
- Next point of focus is India performing well ahead of expectations and should provide a long runway of demand for commodity and infrastructure.
- Supply-side – no one is investing; CapEx is down 2/3 from its peak. The key focus for large mining companies remains on cash generation, balance sheet restoration and returning capital to shareholders.
- Boards and Treasury function having more control over capital allocation.
- Overall, macro demand/supply equation supportive for commodities.
- Cost inflation is rising across a range of inputs.
- Resource sector Clarion view that automation of transportation is critical. Artificial Intelligence and digitalisation is being used to optimise and standardise mining processes.
- Mining companies are increasingly having to lead with a social licence to able to do business.
- Overall, market remains underweight in its ownership of resource companies.

Technology
(Xero)

- Xero started in the UK as a challenger business. Gary Turner (CEO UK Xero) identified the opportunity ten years ago that the Cloud would be an attractive platform for accounting software. The Cloud can bridge the gap between the accountant and SME businesses.
- Today, Xero is the market leader in UK Cloud. Smaller competitors ran out of puff; Xero the only one to graduate to the Premier League to take on main competitor Sage.
- Sage incumbent competitor, historically dominant market share. Sage was the first to market to bring computerised accounting. They focus on customer service ahead of software development. Primarily a desktop accounting application, Sage accounting applications are across the entire market. Sage dominates the mid-market accounting business, but Xero has overtaken them in micro and small business software application accounting.
- Sage was not fast enough in adapting to cloud-based accounting. Xero has first mover advantage in converting accounts to a cloud model.
- Xero purely focuses on micro/small SME businesses; one to 20 employees and cloud-based.
- Xero is a subscription-based model. 1.6% churn per month or 20% per annum. At micro SME market constant state of change. 200,000 new SME businesses created each year.
- There are 5.7m registered business entities in the UK, broken into segments; 2.7m businesses are VAT registered and employ at least one person (require quarterly returns).
- There are 20,000 accountant practices in the UK. One-third of Xero's customers come directly to Xero, while accountants or bookkeepers direct two-thirds.
- UK Government is legislating tax (Make tax Digital Scheme) to become digital for SME's. A mammoth directive by Government which underestimated the task. The first phase is that all VAT businesses need to submit tax digitally by March 2019.
- Tax remains mostly paper-based for SME's, but the direction of travel is moving to digital.
- Xero is well placed to participate in the move to digitalising entire SME tax system.
- Cloud accounting is becoming much bigger than desktop accounting.
- A key challenge for Xero is moving from the micro end of small business to tackle mid-market segment; this requires major upgrades in functionality around stock take, payroll, pension and procurement. For Xero to go to 20-50 employee businesses requires a lot of work.
- The opportunity exists for Xero to extend its offering in Europe.

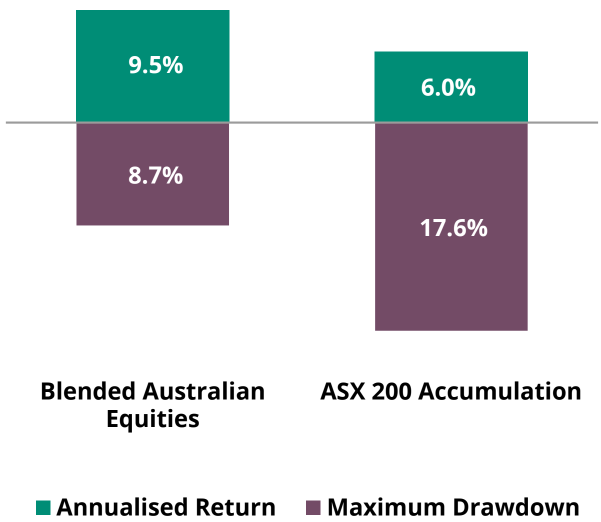
Benefits of Active Management

Performance and Risk (%) Comparison since Inception

A key benefit of active portfolio management is the recognition that return and risk are inseparable. A core portfolio objective of the Australian Income Portfolio is to generate returns that exhibit lower volatility and greater downside protection relative to the ASX 200 benchmark index. The accompanying chart illustrates the value of understanding the interlocking nature of return and risk.

The chart below shows both the annualised return (green bar) generated by the Australian Income Portfolio compared with ASX 200 Accumulation Index, and the maximum loss/drawdown (purple bar) in the value of the portfolio compared to the ASX 200 Accumulation Index since the inception of the portfolio in May 2014. Maximum drawdown measures the magnitude of the worst loss an investor would have incurred by investing in the portfolio or benchmark. Drawdown is a useful measure of risk management as it indicates the portfolio's response to periods of market stress as well as the relative sensitivities to market risk.

Return and Drawdown since Inception



Our investment stance is predicated by two central tenets:

- At a portfolio level we want to broadly participate when equity markets rise, but importantly we want the portfolio to be able to decline less when the market declines; and
- With a portfolio buttressed by a solid cash position, we can be more assertive in participating when the market is low, thus providing a better chance of participating meaningfully in a subsequent market recovery.

Investment Conclusion

An extended period of investment tranquillity, characterised by globally elevated equity markets and historically low volatility, was disrupted in February. The spectre of higher global interest rates and the menace of geopolitical tensions underpinned the modest retracement of equity prices over the March quarter. Indeed, investors reawoke to the axiom that equity markets are subject to periods of heightened volatility.

We remain alert to the possibility that equity markets may remain unsettled for the foreseeable future. Nonetheless, we are encouraged that through careful research we can find pockets of value and opportunity. Our elevated cash reserves in the Australian Income Portfolio affords the ability to invest when an opportunity is illuminated.

Marcus Bogdan
Chief Investment Officer
Blackmore Capital

Appendix

Portfolio Objective

The portfolio seeks to deliver long term growth in both capital and income by investing in Australian listed equities. The portfolio aims to do so with lower volatility and greater downside protection relative to the S&P/ASX 200 Accumulation index benchmark.

Investment Principles

Our investment approach aims to generate long-term risk-adjusted returns, by investing in companies that focus on generating high-quality earnings and operate in industries that exhibit favourable long-term growth prospects. More broadly, we consider a range of attributes which we believe are important qualities in the companies in which we invest. We construct and manage the Australian Equities Income Portfolio with eight consistent guiding principles:

- Grow capital and income over the long term;
- Focus on the quality of company earnings;
- Identify quality assets at an attractive valuation;
- Generate a suitable return on capital employed;
- Invest in companies operating in robust industry structures;
- Select for balance sheet latency and sustainability of dividend income;
- A corporate governance structure that actively promotes alignment with key stakeholders; and
- A vigilant process of portfolio risk analysis.

Portfolio Changes

Over Q3 FY18 we made several changes to the Australian Income Portfolio. The core changes in the portfolio were:

January 2018:

Purchased: Steadfast Group (SDF) – Established in 1996, Steadfast Group (SDF) is the largest general insurance broker network and the largest underwriting agency in Australasia. SDF provides products and services to over 360 insurance broker businesses across Australia, New Zealand and Asia. Since its IPO listing in 2013, SDF has delivered strong underlying earnings per share growth. Earnings guidance for FY18 implies EBITA growth of +11.7%. A strong balance sheet supports SDF with a gearing ratio of 16% (as at 30 Sept 2017). Over recent years, SDF has progressively increased its dividend per share, most notably, in FY17 increasing its dividend by 17%.

Add: Wesfarmers (WES) – With risk assets broadly enjoying elevated valuations, we are increasingly attracted to the defensive characteristics of the consumer staples sector and have built on our position in Wesfarmers. The consumer brands of Bunnings, Coles and Kmart have consistently delivered dependable earnings growth for the Wesfarmers conglomerate. A strong balance sheet and attractive fully franked dividend underpin Wesfarmers.

Sold: Macquarie Atlas Roads (MQA) and Reduced Transurban (TCL) & Viva Energy (VVR) - With the global economy showing tangible signs of improving economic momentum, we are reducing our weighting in "bond-like" equities. Higher bond yields persistently reflect stronger global economic growth. We have, therefore, reduced our weightings in TCL and VVR and sold our position in Macquarie Atlas Roads.

February 2018

Add: Woolworths (WOW) – We have added to our investment in Woolworths. Its clear and focused execution of its retail strategy supports our investment thesis in WOW; noticeable improvements across key financial and operational metrics (including Big W) demonstrate this. Cognisant of the potential structural challenges posed by global online retailers, in December 2017, to better understand the impact that Amazon has had on the UK supermarket sector over the last decade, we visited Tesco (UK's largest supermarket group). Interestingly, it has been the impact of the discounters such as Aldi that have had a more profound impact on the supermarket incumbents. Potentially, this is encouraging for WOW that the grocery sector has attributes around fresh food and convenience that place structural advantages of having an extensive physical store network.

Add: Brambles Ltd (BXB) – We have increased our weighting in BXB following its 1H18 result, which showed tangible signs of revenue and cash flow improvement. Strong underlying profit performances in CHEP Europe/Asia Pacific and IFCO segments, were partially offset by cost pressures in the North America pallets business. Nonetheless, market share gains in the North America business was encouraging. BXB is underpinned by a strong balance sheet with Net Debt/EBITDA < 2 times. We believe BXB remains well positioned to deliver underlying profit growth more than sales revenue over the forecast period.

Reduced: Cleanaway Waste Management (CWY) - We have reduced our overweight position in CWY following a significant re-rating of its stock price over the last 12 months, which has generated a total return more than 40%. Current valuation multiples now look fairly priced. We do, however, continue to hold a position in CWY given its solid operational performance and strong market position in the waste management industry.

March 2018:

Purchased: Rio Tinto - Rio Tinto's (RIO) heritage can be traced back 145 years. Today RIO holds a diversified portfolio of metals and mineral assets. RIO's major products are aluminium, copper, diamonds, iron ore, and thermal and metallurgical coal and uranium. RIO's earnings remain supported by synchronised global economic growth and constrained supply-side capital investment. RIO's focus on cash generation, balance sheet restoration and its ability to return capital to shareholders support our investment thesis on them.

Sold/Added - We have sold our position in hybrids (**ANZPD, NABPB, RHCHPA and SUNPE**) on concern that investment grade credit spreads are now at the lowest spread levels since the Global Financial Crisis. We believe that yields on credit risk assets are no longer attractive compared to the return that can be achieved from either "risk-free assets" and equities. Our preference is to allocate the sale proceeds from the hybrids **toward increasing our cash levels and adding to our position in Coca-Cola Amatil and National Australia Bank**. Both Coca-Cola Amatil and National Australia Bank offer attractive dividend yields.

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