

BKI Quarterly Report



“Expect Volatility and Profit From It”

Benjamin Graham

In this issue:

- ◇ A follow up on our Berkshire Pilgrimage.
- ◇ BKI's Philosophy
- ◇ Woolworths - in our view, a long-term opportunity

Welcome to the seventh issue of the BKI Quarterly Report. We hope you continue to enjoy reading these reports and encourage any feedback. This report (and previous issues) is also available on our website at www.bkilimited.com.au

We intend to cover a few areas in this report. As promised, we provide a few more ideas from our Berkshire Hathaway trip – particularly around the conversations we had with a number of operating companies. We also share a few investment insights into the BKI philosophy and discuss a stock that is dominating our thinking.

Picking up where we left off . . . our Berkshire Pilgrimage

In May we shared a Special Report following our trip to Omaha, Nebraska to attend the 50th Berkshire Hathaway Annual Shareholders Meeting. The correspondence in that Report revolved around the comments and advice shared by Warren Buffett and Charlie Munger. In this Quarterly Report, we discuss the feedback from a number of companies that we met during our travels – both inside and outside the Berkshire stable.

As part of the Shareholder Meeting, Berkshire showcases over 40 of the companies that it owns or has a substantial investment in. It's big – the expo covers the equivalent of four football fields. Products from dozens of Berkshire subsidiaries are for sale. While our Chairman Robert, Tom and I did our bit as shoppers, we also took the opportunity to quiz a number of employees about their operations. Berkshire boasts a diversified collection of American businesses. We believe this is a wonderful, and untapped, resource for us to gauge operating conditions in the United States.

We spoke to home builders, brick manufacturers, railway operators and a range of consumer facing companies (including Brooks Running, Coca Cola, Forest River Motor Homes and Borsheims Jewellers). In short, the US is performing well but the rate of growth has slowed. Growth rates in 2015 will be lower than 2014. As the US moves closer towards full labour capacity, some expect wage inflation to start to become an issue. A lot of people are worried about the fallout from higher interest rates. Overall, the feedback was more cautious than we anticipated.

We also met with ConAgra Foods, an American packaged foods company which is headquartered in Omaha. ConAgra is listed on the New York Stock Exchange, it employs over 25,000 people and generates average sales over US\$17 billion. ConAgra's major brands include Hunt's, Healthy Choice and Swiss Miss Hot Chocolate. We discussed a number of issues, with the comments on the US economy the most interesting, and generally more muted than we anticipated:

“The everyday American is only slightly better off.”

“We remain in the early days of a recovery but everyone is cautious.”

“The shift to value (for consumers) is permanent.”

“The average household income in America is still under \$55k.”

Tom and I also had the privilege of a tour of the brand new Nebraska Furniture Mart (NFM) in Dallas, Texas. It is the largest furniture store in the United States. The numbers are staggering. The store alone is over 50,000 square metres. The warehouse behind the store is another 120,000 square metres and has over 100 parcel pick-up spaces. If one walked up and down through all the racking in the warehouse, you would cover 6 miles! All told, NFM Dallas has 29 football fields of store and warehousing under one roof. Warren Buffett has said that he expects the store's annual sales to hit \$1 billion. Nebraska Furniture Mart has revelled in the shift to value for the consumer. It also has the scale to be an aggressive price leader, and it is using technology to



boost this advantage. The digital price tags at NFM were particularly interesting. The system allows NFM to compare the prices of over 40,000 products against 18 competitors and quickly adjust its pricing so that its customers get the best deal. The innovation, which is not cheap to install, has Tom and I pondering what this disruptive technology means for the Consumer Discretionary sector. It could herald a "race to the bottom" for a number of retailers on price. If anything, it plays into the hands of the bigger retailers that have a volume advantage. History shows that the nature of things is that if you get a lot of volume through your business, you get better at processing that volume. That's an enormous advantage. And it has a lot to do with which businesses succeed and fail.

Bringing it back home

A benefit of the trip to the US is that it allowed us to think a bit more deeply about our business. One of the things that grabbed my attention at the Berkshire Hathaway AGM was the alignment and loyalty between management and shareholders. At the end of each year, more than 98% of Berkshire Hathaway shares are owned by people who were shareholders at the beginning of the year. We can only dream of such loyalty, nevertheless we are hopeful of attracting like-minded shareholders who are willing to invest for the long-term. In light of this, I thought it useful to reiterate what we are trying to achieve at BKI and why.

The BKI model is relatively simple. We aim to invest in quality companies that offer BKI an attractive income stream over a long period of time. We try not to overpay for our stake and limit trading as much as possible. We then want to hold, compound and enjoy the flow of dividends.

In finding quality companies, we meet with management and industry experts and also conduct our own research. We spend a lot of time looking at the financials and prefer companies with low levels of debt.

The Board and management are shareholders in BKI. We do not charge a management fee or performance fee. We are closely aligned with our external shareholders.

We have a simple yet robust investment process and we have no intention of changing that. As Albert Einstein noted "*Everything should be made as simple as possible, but not simpler.*"

In recognition of that, a few comments on what BKI is not intending to do:

- We have no intention on starting a Global Fund, which we get asked about a bit and seems to be the flavour of the month. We see plenty of opportunities in the Australian market over the long term and will continue to enjoy the benefits of long-term dividend investing in quality companies. We will stick to our knitting.
- We have no intention of taking on debt.
- We have no intention of becoming traders. If the investment case permanently changes for the worse on one of our holdings, we will sell it. However, we prefer to hold on to our investments for as long as possible and keep transactions costs to a minimum.
- Despite the index-like cost of running BKI, we will not become index investors. BKI owns over 50 stocks but we are prepared to back ourselves when we have conviction. We do not subscribe to the notion that when it comes to diversification, one should adopt the Noah's Arc approach and own a little of each sector. That is not how diversification should be practiced because all sectors of the economy are not equal when it comes to creating long-term wealth.

- We won't sell everything and become a cash box. We intend to stay close to fully invested. We believe that our shareholders invest in BKI for a long-term exposure to the Australian Equities market and not for us to manage your cash position.

How are we seeing the market currently?

There is seemingly a lot of volatility in the stock market and those who are swayed by short-term news and headlines can be forgiven for being nervous. In today's environment, the line between investing and speculating is becoming blurred. Time horizons have shortened even more than usual, to the point where the market's 4:00 p.m. close seems to many like a long-term commitment.

Despite the noise and short-term gyrations, the Australian market is only 5% lower than its 52 week high. Further, despite an environment of low earnings growth, we still expect to benefit from an attractive dividend stream.

Nevertheless, value is becoming more difficult to find on a short-term basis. We are very selective about the purchases that we are making for the portfolio. Howard Marks, founder of US firm Oaktree Capital made the following comments in a note to his followers:

"It's the job of investors to strike a proper balance between offence and defence, and between worrying about losing money and worrying about missing opportunity. As it stands, I feel it's more important to pay more attention to loss prevention than to the pursuit of gain. We need to move forward, but with caution."

We think that the above summation is pretty close to the mark. When people ask us what we think of the market, we should probably ask "how long is your investment horizon?" One key aspect to risk is how long you expect to hold an investment. For example, stock in Woolworths might be very risky if bought for a day trade or to hold for only a week. But, over a 5 or 10 year period the risk is probably very low.

If there is a pullback in the local market, we will look to add to our holdings. Irving Khan (1905-2015) began his investment career in 1928 and was the oldest active manager on Wall St at the time of his death. He said:

"No one knows when the tide will turn. Those who are leveraged, trade short-term and have bought at a high prices will be exposed to permanent loss of capital. I prefer to be slow and steady. I study companies and think about what they might return over, say, four or five years. If a stock goes down, I have time to weather the storm, maybe buy more at the lower price. If my arguments for the investment haven't changed, then I should like the stock even more when it goes down."

At BKI, we are happy to be slow and steady.

What is dominating our thoughts?

We received a lot of positive feedback on our March quarterly report when we discussed a few of our smaller holdings and the investment attributes that we search for. We thought it appropriate to provide another example, this time in a stock that is attracting a lot of media and investor scrutiny; Woolworths Limited.

We have been selectively adding to BKI's position in Woolworths (WOW) of late. All readers will be familiar with Woolworths, and many are likely to be regular customers. Woolworths listed on the ASX in 1993 and is Australia's largest grocery retailer with approximately 40% market share. The Australian food & liquor business provides more than 80% of WOW's total earnings and includes Supermarkets, and Woolworths Liquor businesses including BWS and Dan Murphy's. Big W provides approximately 4% of total earnings, the hotels business around 7% of earnings and New Zealand supermarket around 7%. WOW entered the hardware market via the acquisition of Danks in 2011 and is now rolling out a larger format chain, Masters.

It is becoming increasingly apparent that, in recent years, Woolworths management lost its focus. In its key Supermarket division, it has allowed Coles to regain share and is experiencing an increasing threat from Aldi. The company has focused on store rollout rather than refurbishment and price – this has damaged customer perception on value and experience.

"One look is worth 100 reports."

Japanese proverb

"It's good to buy a large company with fine businesses when the price is beaten down over worry."

Henry Singleton

However, perception is not necessarily reality. A month ago, we spent the day visiting a number of retail stores across Sydney. We visited new format versions of Aldi, Coles, Woolworths and Masters. We also visited Bunnings and a number of independent hardware retailers. We wanted to get a feel for the new look stores and also test the price perception across Aldi, Coles and Woolworths. We were living the Japanese proverb "One look is worth 100 reports".

There have been recent price comparison surveys indicating that Aldi is considerably cheaper than the incumbents. However, we bought a basket of goods from the three stores and, given the inherent perception, were surprised at how closely priced they were. The following graphic is illustrative.

Product	Aldi	Woolies	Coles
Organic Milk (1L)	\$1.99	\$1.25	\$2.18
Bread (Standard Multigrain)	\$1.99	\$2.00	\$1.90
Foil (30m)	\$2.79	\$4.19	\$2.79
Cling Wrap (60m)	\$1.39	\$1.39	\$1.39
Kleenex Toilet Paper	\$11.99	\$13.20	\$12.00
Uncle Toby's Oats	\$5.87	\$3.59	\$3.55
Self Raising Flour	\$0.75	\$0.75	\$0.75
Vegemite	\$5.50	\$5.51	\$5.00
Rexona Deodorant	\$5.24	\$4.62	\$5.00
Bananas (1kg)	\$2.69	\$1.88	\$1.85
Butter (500g)	\$2.59	\$2.59	\$2.70
Sandwich Bags	\$1.79	\$2.00	\$2.00
Dishwashing Tablets (40 pack)	\$7.99	\$10.00	\$12.49
Cost of the Basket of Goods	\$52.56	\$52.97	\$53.60

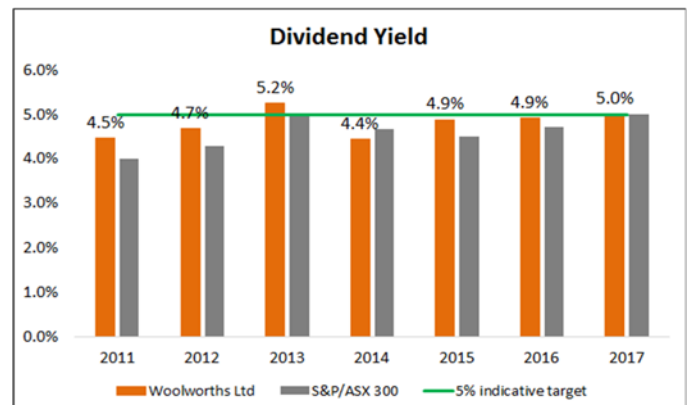
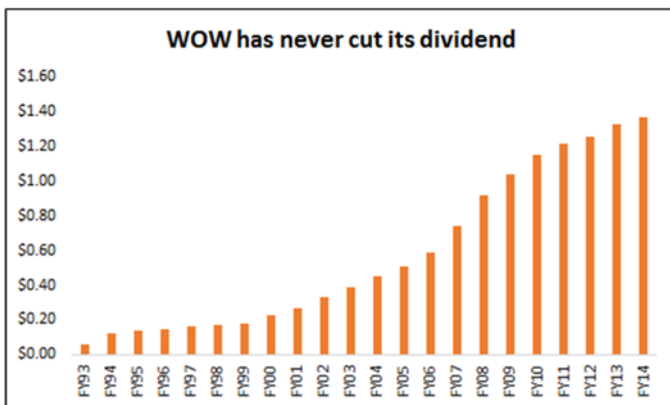
Note: in the "basket", we bought Private Label products when available. Further, in some cases (e.g. Vegemite, Kleenex and Uncle Toby's) we adjusted the price of Aldi as the package size differed to Coles and Woolies. The impact of these adjustments was not material.

In our March quarterly report, we discussed BKI's five investment criteria. That is, we assess Principal Activity/Competitive Advantage, Income, Balance Sheet, Management and Valuation. While we made some comments earlier on WOW's Principal Activity/Competitive Advantage, we also note that Woolworths has 20% greater share than its nearest competitor. It has 14.6m customers, shopping with Woolworths 1.3 times per week. We concede that the foray into hardware has been unsuccessful to date, however we believe the negative sentiment around Masters is overdone given how small it is to the whole WOW investment case.

Woolworths certainly has its operational challenges, but it remains a quality company with excellent returns, brand and market share. At the Berkshire Meeting, both Warren Buffett and Charlie Munger said it was worth studying the investing advice of Henry Singleton. I've since read up on Singleton and one of his quotes strikes a chord in regards to the Woolworths investment case:

"It's good to buy a large company with fine businesses when the price is beaten down over worry."

On income, we remain optimistic on the outlook for a sustainable and growing income stream from Woolworths. The company offers an attractive yield (>7% on a grossed-up basis) and a sustainable dividend. The company has \$2.1 billion of franking credits. Woolworths has never cut its dividend since listing in 1993.



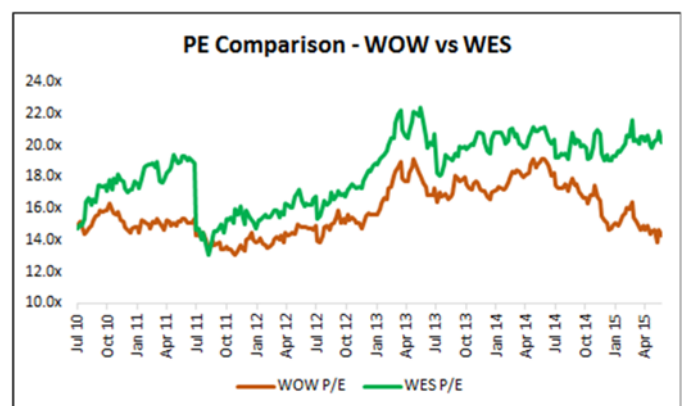
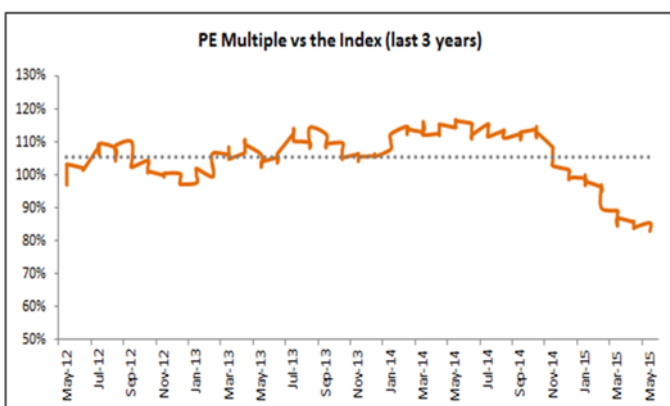
On the balance sheet, WOW is reasonably well positioned and has maintained an A- (S&P) credit rating since 2001. The company generates attractive levels of free cash flow. Its debt maturity is staggered and the company has undrawn facilities in excess of \$2 billion. Interest cover is >13 times.

The Management and Board is an area of obvious concern. Last week, Woolworths announced the upcoming departure of CEO Grant O'Brien. The issue of greater concern for us is the tenure of the divisional heads. The CFO, Head of Supermarkets, Head of Dan Murphys, Head of Big W and Head of Masters have all been in their current roles for less than eighteen months. While we view all as capable operators, companies often need a few people who know where the bodies are buried.

We will watch the announcement of a new CEO with interest and are cognisant that a new CEO may take the often practiced procedure of "clearing the decks" shortly after arrival. While we view management as immensely important in any business, we think that the following quote from Charlie Munger may be relevant in this case:

"We've really made the money out of high quality businesses. And ideally, you get into a great business which also has a great manager because management matters. But it's generally better to bet on the business than on the manager."

Finally, on valuation, we believe that Woolworths offers a very attractive opportunity for the long-term investor. While there is a chance that a new CEO will try to rebase earnings, we feel that a lot of the bad news is known. WOW is trading at a discount to its historical multiple and Wesfarmers.



We may have to be patient on Woolworths but that doesn't bother us. BKI has the succinct advantage that we are not beholden to inflows and outflows from large institutional mandates. The closed end nature of the Company means that we will never be forced sellers. We truly can invest for the long-term and be patient with our holdings. This is important. Of the obstacles that can prevent people from successfully applying some of the sound investing principles found in Benjamin Graham's *The Intelligent Investor*, one of the spots would be reserved for lack of patience - stocks that are unpopular can sometimes remain unpopular and underpriced for a long period of time. It can then become tempting to sell a stock simply because the price of the company isn't moving forward as fast as you'd like.

In all, we consider companies like Woolworths, which are working through some problems, as a great way to engage in value investing. BKI will continue to receive a decent stream of cash that is expected to keep rising each year. It may take a few years for the business to change investor sentiment and drive the valuation upward. However, we believe that we will look back and see that Woolworths was a great opportunity. It remains a long-term profitable company that is still paying good dividends when the stock is cheap and will offer an attractive capital return as we experience the inevitable P/E expansion.

Will Culbert (June 2015)



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