March 2015

BKI INVESTMENT COMPANY LIMITED

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BKI Quarterly Report

Investment Insights

In this issue:

- ◊ **Investing for tomorrow, exploring some of our lesser known holdings.**
- ◊ **Dividend Yield versus Sustainable Dividend Growth.**

Welcome to the sixth 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.

Following our interim and full year results, Tom and I visit a number of Brokers and Advisers across the country to overview of our result and discuss how the portfolio is positioned. In our most recent travels (in late January / early February) we fielded questions on some of our high conviction yet lesser known holdings. While readers will be familiar with and may indeed own our larger capitalised companies – that is, the Big Four Banks, Telstra, Wesfarmers and Woolworths; we thought it would be useful to share our thoughts on some that are not household names. In this report we discuss TPG Telecom, New Hope Group, Invocare and Lindsay Australia. We believe these are compelling investments and we highlight why these companies are well suited to our disciplined investment philosophy and process.

This report is not a discussion about the merits of wide diversification. In fact, with 57 stocks in the portfolio, BKI Investment Company is more concentrated than a number of our Listed Investment Company and Managed Fund peers. We believe that risk is actually reduced by holding fewer stocks where we have a higher degree of conviction. Don't let the lack of a management or performance fee fool you – we are not "index huggers". We don't own 300 stocks! We are an active equities manager and believe we can add value by investing for the long-term in profitable, well managed income producing companies.

Importantly, the Board and Management are also shareholders in BKI so we don't charge a performance fee or management fee. The Management Expense Ratio (what it costs to run BKI) is 0.16% which is a fraction of what most Managed Funds charge and is also significantly cheaper than Australian Market linked ETFs (exchange traded funds). To put the 0.16% in perspective, for every $10,000 invested in BKI stock, the cost to manage that investment is only $16 per annum. We manage this portfolio for maximum long-term value as if we own 100% of it ourselves. In doing so, we hope to attract and retain fellow shareholders who understand the BKI philosophy and process and intend on staying with us for a very long time.

What type of investment attributes are we looking for?

We have previously discussed BKI's disciplined stock selection process using the five investment criteria where we assess existing and potential companies for investment. That is:

- Income
- Principal Activity / Competitive Advantage
- Debt / Strength of Balance Sheet
- Management
- Valuation

Overall, we look at the economic prospects for the business and its industry. We try to evaluate the management; we analyse the level of debt then we assess the price we need to pay. We are very interested in the dividend stream to BKI and ultimately our shareholders. We want to hold an investment for as long as possible and enjoy the benefits of a growing dividend income stream. We like the thinking of a well-regarded American investor John Neff who described dividends as hors d'oeuvres that allow you to snack while waiting for the main meal to arrive. This is Neff's way to describe the act of receiving payouts even when a stock fails to trade at a price that it deserves.

Small enough to be nimble but big enough to be relevant

The BKI Portfolio is currently valued at just short of $1 billion. While we do have aspirations of growing, the portfolio is small enough to be nimble if we want to take a meaningful position in a stock, but also big enough to be relevant in terms of scale.

The ability to be nimble in lesser known companies is valuable. There is an advantage in buying stocks that are not too heavily covered by the broking community as there is definitely a market inefficiency. Often the more that the broking community covers a stock, the less opportunity there is.

BKI is a long only Australian listed equities manager. There are no derivatives, gearing or short selling within the portfolio. We manage the portfolio with a high conviction investment style and we have flexible investment guidelines such as being benchmark unaware, no stock or sector investment limitations and no minimum or maximum cash position constraints.

As we are not "index huggers" we want to share our thoughts on four lesser known companies which we are overweight the index and why they play an important role within the BKI portfolio.

"The very best way to make money in a market is in a small growth company that has been profitable for a couple of years and simply goes on growing".

Peter Lynch

TPG Telecom (ASX Code:TPM)

TPG Telecom is a remarkable success story in one of Australia's most competitive industries – telecommunications. TPG is Australia's fastest growing Internet Services Provider and was formed by the merger between Total Peripherals Group (established by David Teoh in 1992) and SP Telemedia (established by Washington H Soul Pattinson in 2008). BKI was an original shareholder in SP Telemedia Limited and is now a top-10 shareholder in TPG.

We like TPG for a number of reasons, not least of which is its competitive positioning and infrastructure. The 2014 acquisition of AAPT added significant network infrastructure to TPG's existing network. TPG was strong in CBD and metropolitan areas but AAPT provided 11,000km of fibre across six states and territories, including fibre between the capital cities. This creates a significant competitive advantage – particularly when so many competitors are overly reliant on Telstra and NBN infrastructure. The ownership of infrastructure allows TPG to provide its customers with an enticing value proposition.

Internet usage has grown significantly in Australia in recent years. There were 12.5 million internet subscribers in Australia at the end of June 2014, almost a 50% increase from June 2009. What is more telling is the growth in data being downloaded, which has increased tenfold over the same period.

TPG has been superbly led by David Teoh, who has kept a low profile while driving TPG to be a major force in the Australian telecommunications market. He and his team, in particular Chief Financial Officer Stephen Banfield and General Manager Craig Levy, are ruthless on costs and have completed a number of value accretive acquisitions in recent years. This is an important point of differentiation as history shows that many acquisitions are more beneficial to the acquiree rather than the acquirer. TPG, under Teoh, is a disciplined buyer of strategic assets. He doesn't waste excessive money on adviser fees, he takes costs out and he buys businesses that enhance TPG's competitive advantage and boosts free cash flow.

The TPG investment case raises an interesting discussion on dividend yield versus dividend growth. While yield is important, we also want the latter. We avoid yield chasing or buying simply because there is a very high dividend yield. We regard "very high" as over 10%. A high yield can be a red flag for a low-quality businesses with questionable long-term cash flows or a potential debt problem. We prefer sustainable dividend growth and are happy to invest in companies with low starting yields but very high dividend growth rates and long-term capital appreciation potential. For someone who is trying to maximize long-term wealth, these companies are wonderful. TPG is an excellent example.

An investor that bought $10,000 of TPG a little over five years ago would have paid $1.25 per share for a stock offering a yield of 2.3%. At the time, TPG's market capitalisation was approximately $700 million. I use $1.25 per share as this is roughly BKI's cost price. The investor would have purchased 8,000 shares and, as the dividend increased in 2010, received $320 in fully franked dividends that year. In the following four years, that investor would have received $360 in 2011, $440 in 2012, $600 in 2013 and $740 in 2014. So, without doing anything, that investor now has a yield on cost of 7.4% - all in a declining interest rate environment!

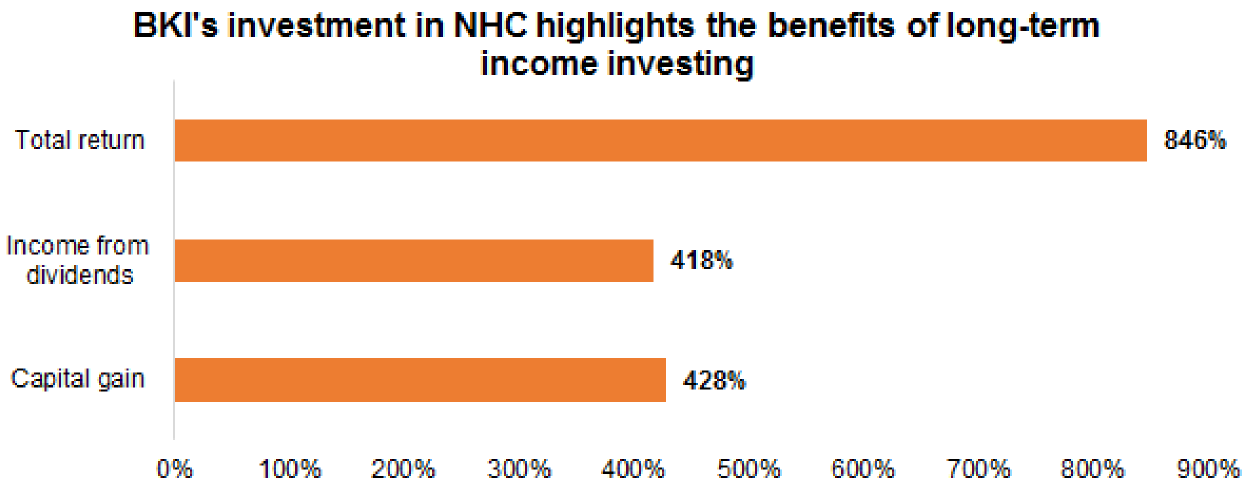
At the time of writing, TPG proposes a Scheme of Arrangement to acquire the Internet Service Provider iiNet in a $1.4 billion transaction. If successful, this will make TPG the 2nd largest internet player in Australia behind Telstra with 25% market share. The TPG share price reacted positively to this announcement, with the shares increasing by almost 20%. TPG's current market capitalisation is now $7.5 billion. Funnily enough, now that TPG is in the Top 100 index, a lot of the big fund managers and brokers are now looking at TPG as an investment option. Hence the beauty of being index unaware, BKI was happy to take a meaningful position in TPG before it was in the index and has reaped the reward.

On a P/E basis, many argue that TPG is looking expensive. However, we remain very comfortable with the outlook, the strategy, the management and the potential for an increased dividend stream. We don't see the sense in selling our winners – it is a bit like saying "This relationship is going so well, I might just break it off!"

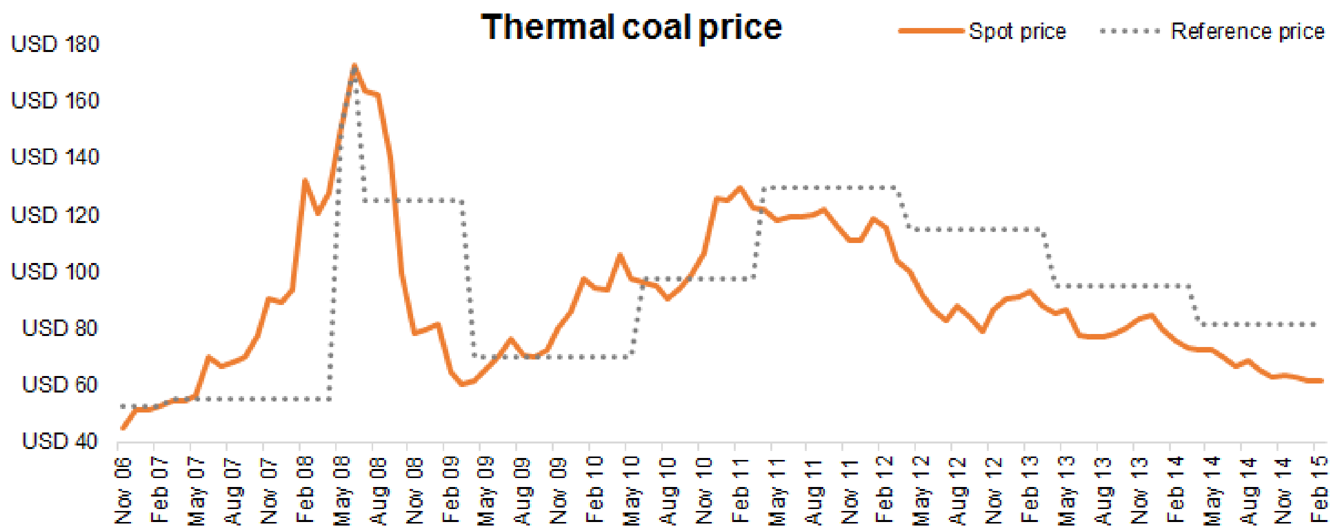
New Hope Group (ASX Code: NHC)

The New Hope Group is a diversified energy company based in South East Queensland. Business interests span coal mining, exploration, port operation, oil, agriculture and investments. NHC has a market capitalisation in excess of $2 billion.

Long term shareholders of BKI will recall a time when NHC accounted for more than 15% of the portfolio. The stock now accounts for about 4% - but note that we have never sold a share. Rather as the fund has grown from $174 million at time of listing in 2003, we have diversified the portfolio. The long-term nature of this investment and the dividend income that BKI has enjoyed over the past decade is testament to one of the key advantages of the Listed Investment Company structure. As a closed end fund, BKI has never been a forced seller or buyer of NHC based on outflows from or inflows into the fund. Our cost price for NHC is $0.60/share. The stock is currently trading at $2.50/share and BKI has collected $2.41/share in ordinary and special dividend income since 2004. NHC operates in a very cyclical industry, but the benefits of investing for the long term are very obvious.



There is no denying that the cycle is currently against NHC. Global demand for thermal coal is robust, supply has been the problem. This is having an impact on price (as illustrated below). Nevertheless, and as noted in a previous BKI Quarterly Report, population growth and urbanisation will be a real driver for consumption of energy. 18% of the world's population still has no access to electricity and 38% is dependent on wood, crop residues and animal waste as their main fuel for cooking and heating. Thermal coal will play an important role in developing economies because it is affordable and reliable.



In terms of the BKI checklist, NHC stacks up well. As noted above, NHC has been an excellent income generator for a long period. We also believe that management is very capable, very cost conscious, have integrity and truly manage for the long term. The other key attribute of NHC is its balance sheet. As at 31 January 2015, NHC had net cash of $1.1 billion on its balance sheet, which equates to about $1.30 per share. This high cash balance is a valuable shock absorber in a difficult external environment. We like companies with net cash and see high cash balances as dynamic, untapped power that can rapidly increase the earnings base.

NHC operates in a commodity industry and the stock is likely to be volatile – we understand this and maintain that a long-term view is crucial, particularly with these types of businesses. We believe that looking ahead a few years can deter the temptation to do something stupid like sell the shares. When we say a "few years" with the BKI portfolio, we are talking 10 to 20 years, not two to three. Global demand for cheap energy will continue – most likely at a rate that surprises us and one that will outstrip the supply response in the long run. NHC is well positioned to be a major beneficiary of this thematic.

Invocare Limited (ASX Code: IVC)

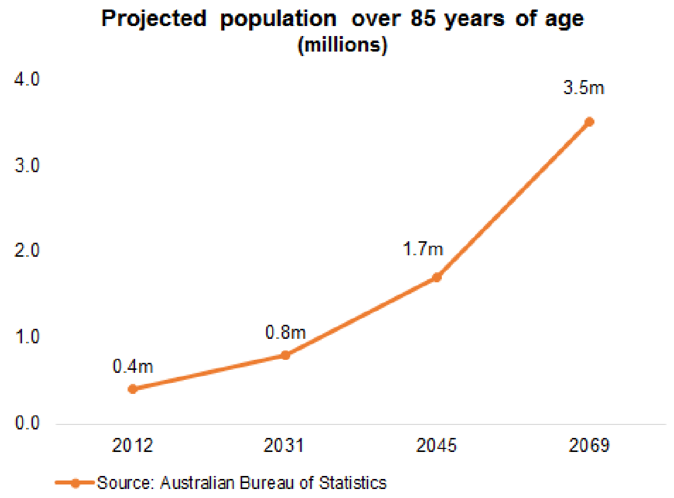
InvoCare
Innovation Vocation Care

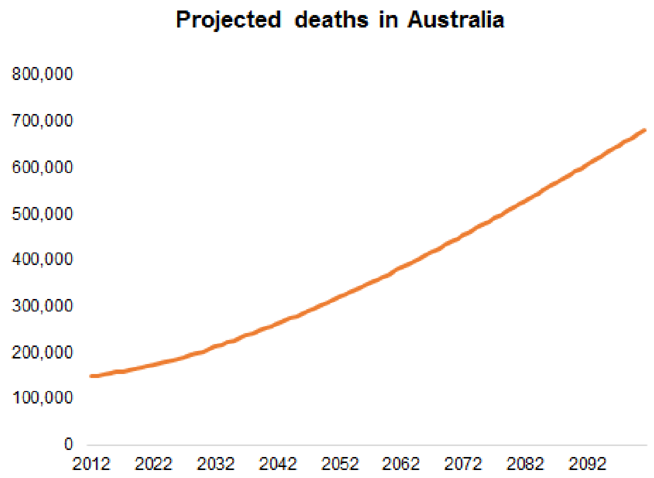
"In this world nothing can be said to be certain, except death and taxes" Benjamin Franklin

InvoCare owns and operates funeral homes, cemeteries and crematoria around Australia, New Zealand, Singapore and from 2015 the United States of America. The company boasts a number of strong brands including White Lady, Guardian and Simplicity Funerals. Invocare Limited was created in 2001 as part of a divestment by Service Corporation International who sold an 80% stake of their Australian funeral division to a consortium led by Macquarie Bank. In 2003 IVC was floated on the ASX at $1.85 per share in a $170 million issue. The market capitalisation is now $1.5 billion.

We try to think about long term business prospects rather than short-term market prospects. While we acknowledge that it is a sombre topic, the fact is that Australia and the rest of the developed world has an aging population. This is one of the key reasons why IVC is a compelling investment for BKI. The aging Australian population will see a gradual increase in the number of deaths in IVC's key markets.

The charts on the following page are illustrative – the demand for funeral related services is underpinned by demographic trends. People are living longer. This also supports our positive view for aged care and our other investments in the Healthcare sector. The growth in population will underpin demand. There were approximately 150k deaths in Australia last year. By 2045, the number of deaths per annum is projected to double to over 300k. With the average cost of a funeral near $10,000, this is a significant industry.





As you would expect with a business in a service industry such as this, Invocare is conservatively managed with a solid balance sheet. IVC is the leading player in Australia and New Zealand with a wide range of brands. This allows the company to provide a wide service offering across a range of budgets. IVC has actively grown its prepaid funerals book, which helps to underpin growth in the medium term.

IVC is expected to provide BKI with a growing income stream over the long term. This growing income stream, which we believe is critically important, is similar to the TPG example we discussed earlier.

Lindsay Australia Limited (ASX Code:LAU)

The three stocks we have already discussed still fly under the radar for most Australian investors. While they account for a very small percentage of the ASX indices, they are no longer minnows – all have an enterprise value in excess of $2 billion. Lindsay Australia on the other hand is still small. Its market capitalisation is $120 million and we believe that this microcap could present a superb long term investment opportunity. That is fine with us, the typical big winner in the BKI portfolio takes 5-10 years to play out.

Lindsay Australia Ltd (ASX Code: LAU) is an integrated transport, logistics and rural supply company. The company has an extensive East Coast network of 33 stores and depots. Its services are fully integrated to provide an "end-to-end" delivery package. LAU is based in Brisbane and employs approximately 1100 people. It was established in 1953 by Tom and Peter Lindsay and is now run by Tom's son, Kim. The Lindsay family are among the largest shareholders in LAU with a 16.8% holding in the company – we like the alignment of management with shareholders.

The Australian transport industry is fiercely competitive, however increased regulation, rising labour costs and the economic slowdown is making it increasingly difficult for traditional "Mum and Dad operators" to survive. A recent ABC News article noted that up to 20 high-profile trucking businesses based in Queensland have folded in the past 18 months. The largest operators are Linfox and Toll, although Lindsay continues to build its share – particularly in refrigerated transport. We will closely watch the ramifications of the recent takeover of Toll by Japan Post. If the acquirers decide to pursue the express post and online deliveries side of Toll more than the traditional trucking business, and we think they will pursue this strategy, then there could be a significant opportunity for LAU.

Australia relies heavily on road transport due to its large geographical size and low population density. Despite a lot of rhetoric, the "road to rail" shift continues to be a pipe dream – Australia's rail network infrastructure is second rate at best.

LAU has been investing quite heavily in recent years. In July 2014 it opened a 9,000m^2 produce facility in Brisbane Markets. The facility has a 3,000 pallet/day capacity and allows Lindsay Fresh to deliver produce twice per day to key supermarket clients in Brisbane. It also has fumigation systems and temperature control storage, and increases the company's ability to compete in import/export markets. This type of innovation is a key differentiator for LAU and improves the value proposition to clients such as Coles and Woolworths.

LAU looks attractive across BKI's key investment criteria checklist. The company is well managed by shareholder orientated people who are passionate about the business. We expect a sustainable dividend stream that will grow over the medium term. The balance sheet is in reasonable shape and LAU takes advantage of attractive finance leases with its trucks. Overall, we believe that LAU is poised to do well over the medium to long term. Frankly, if the business does well, the stock eventually follows.

Will Culbert (March 2015)

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