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BKI INVESTMENT COMPANY LIMITED

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BKI Quarterly Report

Thinking and acting long-term is an important edge

Welcome to the latest BKI Quarterly report – our 12th. This report and previous issues is available on the BKI website at http://bkilimited.com.au/quarterly-reports

There is a wonderful market analogy, which we've borrowed from a Motley Fool (USA) article penned by Morgan Housel earlier this year. Housel wrote:

> *Ralph Wanger was born in 1933, almost to the day of the bottom of the Great Depression. He went on to be not only a great investor but a great investment writer, sharing wit and wisdom in his quarterly shareholder letters.*
>
> *Wanger once analogized the stock market to a man walking his dog in New York. The man has done the same walk for years, starting at Columbus Circle, strolling through Central Park, and ending at the Metropolitan Museum of Art.*
>
> *The dog has boundless energy and never walks in a straight line. He leaps randomly from one direction to the next, stops to smell every leaf, barks at other dogs, and jumps on you for no reason.*
>
> *At any moment, there is no predicting what the dog will do or which way he'll leap. His movements are totally unpredictable. But you know he's heading northeast at about three miles per hour, toward the museum, where he'll eventually end up – because that's where the owner is taking him.*
>
> *"What is astonishing," Wanger said, "is that almost all investors, big and small, seem to have their eye on the dog, and not the owner."*
>
> ***As you navigate your life as an investor, pay more attention to the owner (businesses) and less to the dog (markets).***

Which brings us to the recent round of the Australian reporting season. We view the biannual results as a time to re-view the operating performance of the companies we invest in. It provides an opportunity to hear from management, to review the investment case and ensure the BKI portfolio is appropriately positioned.

We try to avoid short term gyrations in the market. In our view, a company probably doesn't lose or gain nearly as much value day to day as the stock market says it does. We view the market's reaction to the TPG Telecom result, which saw the stock fall 22% losing $2.2 billion in a single day, as an example. We will revisit TPG Telecom later in this report.

How are we seeing the Australian Equities Market?

"The key to making money in stocks is not to get scared out of them. This point cannot be overemphasised"

Peter Lynch

There is a lack of conviction in the mindset of many Australian investors, and reporting season affirmed that. Investor action seems to be tentative, which we see driven by a number of factors:

- A lack of clear political direction which is impacting business confidence
- A lack of broad based growth in the economy
- A lack of high quality Initial Public Offerings (IPOs)
- A market trading above its historical averages on valuation multiples such as Price-to Earnings multiples
- A buoyant business cycle is now seven years old
- Corporate Australia being focused on cost out strategies rather than investing in their businesses for growth

The above list comes across as negative and we've written it that way intentionally. It is designed to highlight a phenomenon in behavioural economics called "negativity bias" which causes investors to put more weight on bad news than on good. The brain tends to react to negative events more quickly, strongly and persistently than to good ones. This is where it becomes important to hold your nerve and maintain a long term perspective. Consider that shares in Apple increased more than 6,000% from 2002 to 2012, but declined on 48% of all trading days. It is never a straight path up!

We don't dispute that it's tougher to generate the seemingly easy returns of those halcyon days of fiscal 2013 and 2014, when the market returned 22% and 17% respectively. However, we remain emboldened by the fact that thinking and acting for the long-term remains one of the more important edges when investing.

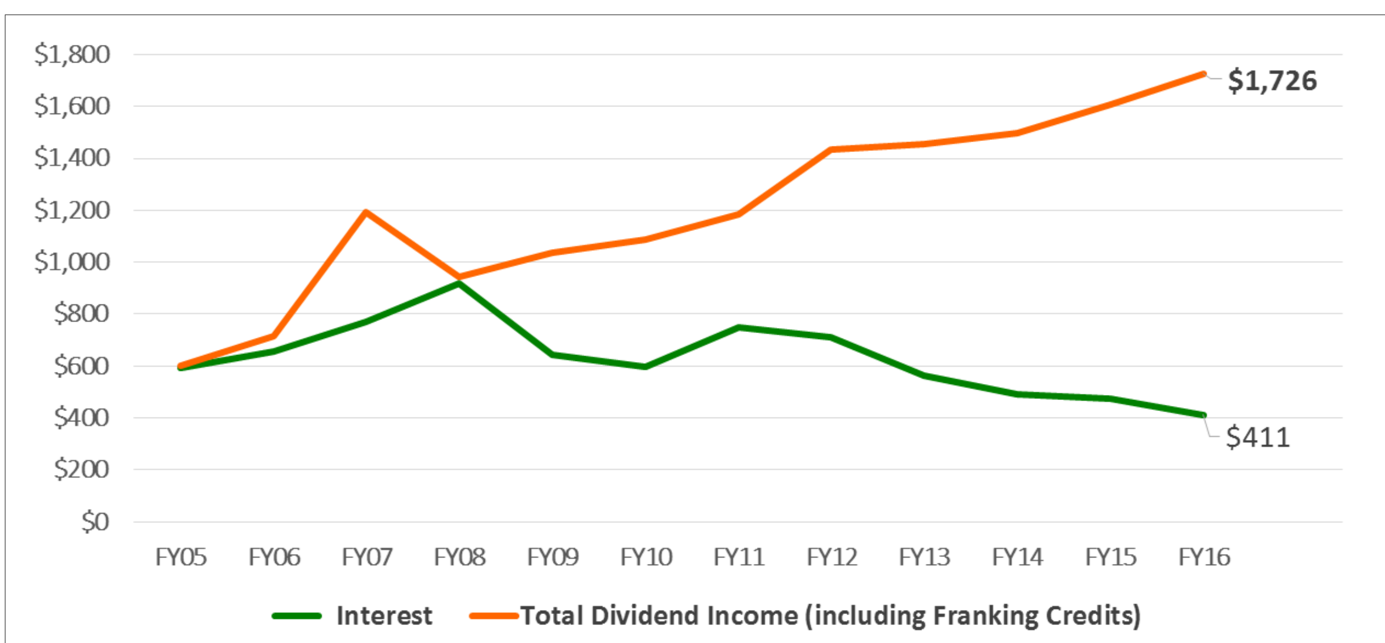
There are a number of reasons to be optimistic:

- Corporate balance sheets are in good shape. Corporate gearing is forecast as below average in fiscal 2017. For those companies that can borrow sensibly, there is scope to take advantage of low interest rates.
- Companies that have successfully implemented a disciplined cost culture will be better placed once broad based economic growth returns.
- Expectations have been revised down for many parts of the market as investors adjust to a lower growth world. Overall earnings per share growth in fiscal 2017 is now expected to be low single digit dragged down particularly by resource stocks. This is important as stock prices are driven by what is expected to happen and less so by what has happened.

- A market lacking direction often causes investors to act irrationally. As long term investors, we remain confident that we will have opportunities to buy quality companies at attractive prices. Later in this report we discuss one of our recent purchases, Flight Centre, and the rationale behind it. In the meantime, BKI boasts a well-diversified portfolio that offers an attractive mix of growth and yield.
- The Australian equities market continues to offer a reasonable yield, particularly when compared against the less palatable rates on offer from Term Deposits.

On the final point, we often use the following chart to highlight the importance of a growing dividend stream in a falling interest rate environment. The chart tracks the dividend income received by an investor who purchased $10,000 of BKI shares on listing in 2003 (and reinvested the dividends) versus investing that $10,000 in term deposits. In fiscal 2016, that investor would have received $1,726 in BKI dividends and franking credits (or 17% yield on cost), well above the $411 that a term deposit would have delivered.

The Advantage of a Growing Dividend Stream in a Falling Interest Rate Environment



What did we learn from Reporting Season?

The August / September results season was mixed. Companies exposed to offshore growth performed well as did those with infrastructure and housing earnings. Offsetting this was subdued stock price performance from the insurance sector, resources, telcos and aged care.

Stocks on high PE (price-to-earnings) ratios that delivered weaker than expected results or soft outlook statements were punished by the market. Momentum based investors, who adopt a system of buying stocks that have had high returns over the past three to twelve months, and selling those that have had poor returns over the same period, are having a more challenging time.

This is a change. Over the last couple of years, investors have been willing to pay up for growth stocks in a below-trend economic environment. With valuations now looking stretched for a number of these companies, investors are becoming more favourably disposed towards value.

A few comments at a sector level:

Earnings reported by the banks have been muted over the past twelve to eighteen months for a few reasons. Lower global interest rates negatively impact their margins. While impairments remain at exceptionally low levels, a mild increase in bad debts also hurt earnings. Australian Banks have been required to hold more capital in the last 18 months, which has trimmed returns. The market remains divided on the ongoing capital requirements for the Major Banks. Following a number of meetings in August, we are more comfortable that the Banks are well placed on their global capital requirements.

The Insurers delivered soft results as they recovered from a challenging first half of natural disasters. The sector is also reliant on investment returns and has suffered in a low interest rate world.

Profits delivered by the Resources sector were generally weak, driven by falling commodity prices. There are now some green shoots from increasing spot commodity prices. However, many of the major Australian listed resources companies are focused on cost out strategies and protecting their balance sheets. In this scenario, the dividends aid to shareholders suffer. BKI remains underexposed to the resources sector generally as the dividend yield and growth prospects are not compelling.

The results from the telecommunications companies were reasonable but the market took issue with the outlook statements provided. As readers are aware, BKI is a long-term holder of both Telstra and TPG Telecom. We believe that by owning both we benefit from a combination of yield from Telstra and growth from TPG. At current prices, Telstra offers shareholders a 6.4% fully franked dividend. In fiscal 2016, TPG increased its dividend by 26%. We think this is an attractive combination!

In the near term, the telecommunications industry remains competitive. The sector is entering a period of increased capital investment as these companies improve their infrastructure and also prepare to compete in a NBN world. This may put pressure on fiscal 2017 earnings. At BKI, we want companies to invest in their businesses if that investment generates an attractive return. The market is now viewing TPG as if it faces sharply reduced earnings growth. We disagree. We are always willing to look forward a few years when there is a productive strategy in place being executed by a capable management team—that is certainly our view on both TPG Telecom and Telstra.

After the result, TPG Executive Chairman noted that *"We have to keep investing in infrastructure to bring benefit to our shareholders, so we'll keep doing that. I care about the future of the group, I think we have to plan ahead. What is good for the company, what is good for shareholders, is long term. I can't look at the company in the next few months, so we have to plan out long term for the benefit of our shareholders."*

Finally, we were surprised with how investors reacted to news flow around dividends. Two years ago, companies were rewarded for paying out high dividends to shareholders. It seems that the opposite was the case in the latest round of results. Investors are desperate for growth and seemed to bid up those companies that cut dividends if there was a viable path to growth.

A new stock for the Portfolio: Flight Centre

As BKI shareholders are aware, we are investors not speculators. We try to identify companies we want to own for the long-term. We do not trade excessively and our portfolio turnover in fiscal 2016 was only 8% — a fraction of the industry average. We do a lot of research before establishing a new position in the portfolio. We test that investment against other alternatives and indeed companies that are already in the portfolio. As "*One Up on Wall Street*" author Peter Lynch notes, "*the best stock to buy may be the one you already own*".

With this in mind, we established a position in Flight Centre Limited ("FLT") in August and the investment accounts for just over 1% of the Portfolio. We have been watching FLT for some time and have had a number of interactions with the management team in recent months. When the company lost a third of its market value between March and June, we intensified our research efforts.

In Flight Centre, we see a company whose stock price is temporarily punished by a market that lacks patience. FLT is managed by a highly experienced team of people with significant shareholdings. The team has successfully invested in new brands and markets in the past and is currently undertaking another round. Almost half the Group's revenue is now derived from offshore. FLT is laying the foundations for future growth – it is investing in its brand, significantly growing online presence and expanding its corporate travel presence. In fiscal 2016 it completed seven acquisitions.

We believe that Flight Centre performs well across BKI's investment criteria. By way of short summary, we note that:

Income: FLT offers a reasonable yield (~4.5% or >6% on a grossed up basis) which we expect to be sustainable. There is potential for additional capital management in the medium term.

Principal Activity: Flight Centre is Australia's leading travel business. The business is diverse across brands and geography. This is a competitive industry and FLT competes against traditional travel agents and a range of online players.

Debt / Balance Sheet: FLT is in a strong cash position. It is net cash by $430 million. The company will invest in a variety of growth options in the near term, however capital management initiatives are possible in the medium term.

Management: Experienced management team with plenty of skin in the game. Graham Turner (67) is the key man. However, he has a number of very capable people in Senior Management who have been with the business for a long time.

Valuation: FLT has underperformed the market significantly over the past year. The stock is now looking more attractive from a valuation perspective. It is currently trading on a PE multiple of 14x.

In conclusion, we do not deny that this is a challenging market and attractive investment opportunities are not as prevalent as they once were. However, opportunities will always emerge for the patient, opportunistic and long-term investor. To quote Peter Lynch again, *"the key to making money in stocks is not to get scared out of them. This point cannot be overemphasised."*

We leave you with a quote from economist Tim Duy who said*:* *"As long as people have babies, capital depreciates, technology evolves, and tastes and preferences change, there is a powerful underlying impetus for growth that is almost certain to reveal itself in any reasonably well-managed economy."*

Will Culbert (September 2016)

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