October 2018

BKI INVESTMENT COMPANY

ABN: 89 615 320 262

BKI INVESTMENT COMPANY LIMITED

QUARTERLY REPORT

Spin-offs: often an underappreciated investment opportunity

With the impending demerger of Coles by Wesfarmers Limited, we provide a high-level assessment of the proposal. We also highlight that spin-offs have been a good opportunity for investors historically.

CONTACT ASSET MANAGEMENT

BKI is managed by Contact Asset Management AFSL 494045

Welcome to the 20th issue of the BKI Quarterly Report, prepared by Contact Asset Management. These reports provide us with an opportunity to communicate with shareholders on high-level topics of interest. The reports are available on the website at www.bkilimited.com.au. We also encourage you to subscribe to the BKI mailing list.

Spin-offs: potentially astoundingly lucrative investments

In November 2018, a much-anticipated transaction is expected, Wesfarmers demerger of Coles Ltd ("Coles").

Wesfarmers ("WES") originated in 1914 as a Western Australian farmers conglomerate. It listed on the ASX in 1984. The conglomerate is now one of Australia's largest listed companies with a market capitalisation in excess of $45 billion. WES has grown through acquisition, but also organically through an unrelenting focus on shareholder value creation and adequate returns on capital. Its largest acquisition was the November 2007 acquisition of Coles Group for $19.3 billion. The acquisition bought Coles, Kmart, Target and Officeworks under the WES banner, and doubled Wesfarmers' earnings.

In March 2018, WES announced its intention to undertake a demerger of Coles. As part of the demerger:

- WES will retain a 15% interest in Coles, with the remaining Coles shares distributed to existing WES shareholders on the basis of one Coles share for every WES share held; and
- *flybuys* will be established as a standalone business held on a 50/50 joint venture basis by WES and Coles.

What is a spin-off / demerger?

A spin-off is the creation of an independent company through the sale or distribution of new shares of an existing business or division of a parent company. A spinoff is a type of divestiture. Generally, the rationale for a spin-off is the belief the spun-off company will be be worth more as an independent entity than as parts of a larger business.

In this report, we use the terms demerger and spin-off interchangeably. However, we are essentially talking about the same thing.

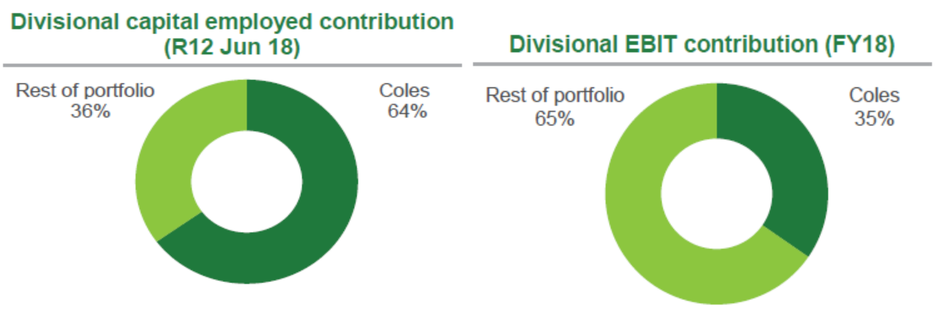
There have been several spin-offs in the Australian stock market over the last fifteen years. Notable transactions include:

* BHP Billiton / South32	* NAB / Clydesdale Bank	* Toll / Asciano
* Brambles / Recall	* Amcor / Orora	* Orica / Dulux Group
* Fosters / Treasury Wines	* Boral Ltd / Origin Energy	* CSR / Rinker
* Fairfax Media / Domain	* Tabcorp / Echo	* Alumina / WMC

As part of this Quarterly Report, we thought it appropriate to provide some initial thoughts on the proposed WES / Coles demerger. In addition, we thought it useful to share some evidence on the performance of spin-offs over time. Many top global investors have identified spin-offs as sources of value creation – the evidence is compelling both domestically and offshore.

Why is WES demerging Coles?

There are a number of reasons that WES has noted for the decision to demerge Coles. However, a primary driver relates to capital allocation and the returns that WES can achieve on its capital. In FY18, Wesfarmers' retail operations (which include Coles, Bunnings, Department Stores and Officeworks) contributed 82% of group EBIT and 87% of group capital employed. Coles represented 32% of group EBIT but 64% of capital employed.



Source: Wesfarmers: Demerger of Coles Presentation (5 October 2018). R12 refers to Rolling 12 months to 30 June 2018.

Coles is a low margin, low return on capital division compared to most of the other WES divisions. This is not to suggest that Coles is not a good business – these metrics are typical for the supermarket industry.

WES has successfully turned the Coles business around. The Management and Board believe that, as it stands, WES and Coles have different investment attributes and growth prospects. The expectation is that they will perform better as separate entities. The transaction does not necessarily indicate a lack of confidence by WES management on the prospects for Coles. WES decision to maintain a significant shareholding in Coles (15%) and have Board representation is testament to that.

What does the demerger mean for BKI?

WES is an important component of the BKI Investment Company portfolio. At 30 September 2018, WES accounted for 4.7% of the portfolio and was BKI's fifth biggest position.

Assuming the proposed demerger goes ahead, BKI will receive one Coles share for every share that we own in WES.

What is our assessment of the Investment Case for the stand-alone Coles?

A scheme booklet has been released to WES shareholders and we continue to work through the machinations of the Coles investment case.

We like Coles for its strong market position, reputable brand and well-located stores. Coles has 809 supermarkets Australia wide and 31% market share.

The prospects for income and dividends are attractive. Coles is expected to generate steady earnings growth and cash flow. The company has stated it will pay out between 80%-90% of earnings as dividends.

Our initial assessment is that the balance sheet is reasonable. WES has been careful not to overload Coles with too much debt. A conscious decision has been made to enable Coles to support investment grade credit ratings. Gross debt looks to be around $2 billion but there are also significant lease commitments that are long-tenure totalling $10 billion. We anticipate that Coles has quite an intensive investment programme ahead of it, so a supportive balance sheet will be important.

Coles will boast an experienced Board and Management team. We will follow with interest the equity ownership in Coles from the Board and Management. We prefer to invest in companies where management interest is aligned with ours.

We certainly appreciate there are a number of attractive fundamentals in the Coles investment case. A big unknown remains valuation.

How have spin-offs performed historically?

Every spin-off is different as the mechanics and valuation metrics for each are unique. The other important ingredient is the calibre of the management team running the spin-off.

History suggests that spin-offs have generally provided investors with outsized returns. A study by Deloitte and The Edge found that since January 2000, the worldwide index class of spin-offs has generated over 10x the average gains of the MSCI World Index.

One interesting dynamic is that spin-offs often underperform early on. US investor Mohnish Pabrai notes that: "Too often, shareholders shrug off spinoffs and sell the spinoff shares promptly upon receipt. Institutional investors in particular sell spinoff shares because they are either not allowed to own stocks below a certain market cap or they simply don't understand the new spun out business. This leaves money on the table and creates selling pressure in the first few quarters after the spinoff. It is therefore a good idea to invest in spinoffs after they have been around for a few quarters."

The other reason for the early underperformance can be that the size of the stake in the new company is small from an overall portfolio sense. As detailed in his book "Margin of Safety, Risk Averse Value Investing Strategies for the Thoughtful Investor," Seth Klarman describes the dilemma an institutional investor faces;

“An institutional investor managing $1 billion might hold twenty-five security positions worth approximately $40 million each. Such an investor might have owned one million Tandy shares trading at $40. He or she would have received a spinoff of 200,000 InterTAN shares having a market value of $2.2 million. A $2.2 million position is insignificant to this investor; either the stake in InterTAN will be increased to the average position size of $40 million, or it will be sold. Selling the shares is the path of least resistance since the typical institutional investor probably knows little and cares even less about InterTAN. Even if that investor wanted to, though, it is unlikely that he or she could accumulate $40 million worth of InterTAN stock, since that would amount to 45 percent of the company at prevailing market prices (and that almost certainly would violate a different constraint about ownership and control).”

However, after the initial period, when this wave of selling is done, an investment in a spin-off can be lucrative.

What do some of the World’s Best Investors say about spin-offs?

Peter Lynch, legendary US investor and author of *One Up on Wall Street*, discussed spin-offs in his book. He notes that “Spin-offs often result in astoundingly lucrative investments”. He believes parent companies do not want to spin off divisions that will go on to fail as this would reflect poorly on the parent. Lynch also notes,
“And once these companies are granted their independence, the new management, free to run its own show, can cut costs and take creative measures that improve the near-term and long-term earnings.”

"There are plenty of reasons why a company might choose to unload or otherwise separate itself from the fortunes of the business to be spun-off. There is really only one reason to pay attention when they do; you can make a pile of money investing in spin-offs" Joel Greenblatt

“Some spin-offs have similar dynamics, though they need to be assessed case by case. A spin-off is when a large company divests a subsidiary by distributing the subsidiary’s shares to the parent company’s shareholders. Over the years we have found that carefully selected spin-offs are terrific opportunities” David Einhorn

“Charlie [Munger] mentioned if an investor did just three things the end results would be vastly better than the rest. 1) Carefully look at what the other great investors have done, 2) Look at the cannibals, i.e. businesses buying back huge amounts of their stocks, and 3) carefully study spin-offs. Charlie said that an investment operation that focussed on these three attributes would do exceedingly well” Mohnish Pabrai

"Spin-offs were another thing that attracted our interest. We figured, if someone is spinning off pieces like that, it is a clear indicator that they are concerned about shareholder value" Robert Robotti

"Both spin-offs and merger securities are distributed to investors who were originally investing in something entirely different. Both spin-offs and merger securities are generally unwanted by those investors who receive them. Both spin-offs and merger securities are usually sold without regard to the investment merits. As a result, both spin-offs and merger securities can make you a lot of money" Joel Greenblatt

BKI and Contact Asset Management’s approach

As many of the sentiments above suggest, spin-offs and demergers need to be assessed on a case-by-case basis. We intend to do that with Coles – particularly given that both WES and Coles will be a meaningful proportion of the BKI portfolio.

However, we are comforted by the fact that often the benefits are realised for those that are willing to take a long-term view.

Will Culbert
Contact Asset Management

<u>Sources:</u>

Wesfarmers – Coles Demerger Scheme Booklet and Investor Presentation (5 October 2018)

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