



# Product Review

## BKI Investment Company Limited

ISSUE DATE 17-10-2018

### About this Review

ASSET CLASS REVIEWED	AUSTRALIAN EQUITIES
SECTOR REVIEWED	AUSTRALIAN LARGE CAP
SUB SECTOR REVIEWED	LIC
TOTAL COMPANIES RATED	11

### About this Company

LIC REVIEWED	BKI INVESTMENT COMPANY LIMITED
ASX CODE	BKI
ASX LISTING DATE	12 DECEMBER 2003
COMPANY OBJECTIVE	GENERATE GROWING INCOME STREAM IN THE FORM OF FULLY FRANKED DIVIDENDS DISTRIBUTION AND LONG-TERM CAPITAL GROWTH THROUGH THE LONG-TERM INVESTMENT IN A PORTFOLIO OF ASSETS
RECENT CAPITAL MANAGEMENT	DRP, SPP
MANAGEMENT COSTS	0.16% P.A.

### Market data

MARKET CAPITALISATION	\$1091M
SHARES ON ISSUE	728M
SHARE PRICE (16-10-2018)	\$1.50
52 WEEK HIGH/LOW SHARE PRICE	\$1.76 / \$1.49
NTA (28-9-2018)	\$1.63
52 WEEK HIGH/LOW NTA	\$1.67 / \$1.54
SHARE PRICE PREM/(DISC) TO NTA	-7.98%

### Board of Directors

NO. OF DIRECTORS	4
MAJORITY INDEPENDENT DIRECTORS	NO
CHAIRPERSON	ROBERT MILLNER
AGGREGATE DIRECTORS FEES	FY18 ACTUAL \$222K

### About the Investment Manager

INVESTMENT MANAGER	CONTACT ASSET MANAGEMENT PTY LTD
OWNERSHIP	80% STAFF, 20% WASHINGTON H SOUL PATTINSON
ASSETS MANAGED IN THIS SECTOR	\$1.1B
YEARS MANAGING THIS ASSET CLASS	14

### Investment Team

PORTFOLIO MANAGER	TOM MILLNER, WILL CULBERT
INVESTMENT TEAM SIZE	4
INVESTMENT TEAM TURNOVER	LOW
STRUCTURE / LOCATION	SYDNEY

### Investment process

STYLE	ACTIVE - CORE
MARKET CAPITALISATION BIAS	MID-TO-LARGE
BENCHMARK	S&P/ASX 300 ACC. INDEX
TYPICAL STOCK NUMBERS	45-60
STOCK AND CASH LIMITS	BROAD

### Company rating history

OCTOBER 2018	RECOMMENDED
OCTOBER 2017	RECOMMENDED

### What this Rating means

The 'Recommended' rating indicates that Lonsec has strong conviction the financial product can generate risk adjusted returns in line with relevant objectives. The financial product is considered an appropriate entry point to this asset class or strategy.

### Scope of this rating

- Lonsec has used its Managed Funds research process in forming an opinion on this Listed Investment Company's (LIC or Company) ability to meet its stated investment objectives. The extent of any 'point-in-time' divergence between BKI's share price and its underlying Net Tangible Asset Value (NTA) per share is not part of the ratings consideration.
- Lonsec does consider whether structural or management issues could potentially lead to a LIC trading at a significant discount to its NTA over an extended period of time without any recourse for shareholders. This aspect forms part of the wider qualitative and quantitative assessment that Lonsec undertakes when assessing the relative investment merits of a LIC.

### Strengths

- BKI has a strong long-term track record of paying fully franked dividends and meeting its investment objectives.
- Investment committee and Board of Directors comprise of highly experienced individuals with long co-tenure.
- Contact is owned 80% by BKI's portfolio managers, Tom Millner and Will Culbert, leading to a strong alignment of interest with share-holders.
- BKI has a very low MER (annual fixed costs are 0.16% of NAV for FY18).
- BKI has reasonable size and liquidity.

### Weaknesses

- Sell discipline on valuation grounds potentially diminished due to the 'buy and hold' low turnover philosophy and tax awareness.
- High level of related-party risk including the provision of services (including investment management) by related entities and direct share-holdings in related businesses.
- The co-PM structure at contact could potentially diminish accountability for the shareholders.
- Contact has a smaller investment team of four.

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## Company Risk Characteristics

	LOW	MODERATE	HIGH
BUSINESS SUSTAINABILITY RISK		●	
CAPITAL VOLATILITY			●
SECURITY LIQUIDITY RISK		●	
SECURITY CONCENTRATION RISK		●	

Risk categories are based on Lonsec's qualitative opinion of the risks inherent in the financial product's asset class and the risks relative to other financial products in the relevant Lonsec sector universe.

## BIOmetrics

### Aggregated risks

	1	2	3	4	5	6	7
STD RISK MEASURE						●	

A Standard Risk Measure score of 6 equates to a Risk Label of 'High' and an estimated number of negative annual returns over any 20 year period of 4 to less than 6. This is a measure of expected frequency (not magnitude) of capital losses, calculated in accordance with ASFA/FSC guidelines.

	LOW	MODERATE	HIGH
RISK TO INCOME		●	

### Features and benefits

	LOW	MODERATE	HIGH
COMPLEXITY		●	
ESG AWARENESS	●		

### Fee profile

	LOW	MODERATE	HIGH
FEES VS. UNIVERSE	●		
FEES VS. ASSET CLASS	●		
FEES VS. SUB-SECTOR	●		

Fee BIOmetrics are a function of expected total fee as a percentage of expected total return.

## What is this Company?

- BKI is a mid-sized LIC (by market capitalisation) that is listed on the ASX. First listed in 2003, BKI has a current market capitalisation of \$1.12bn and has ~17,000 mostly retail shareholders. BKI currently has 725m shares on issue.
- BKI is externally managed and its primary investment objective is to generate a growing stream of fully franked dividends. While largely benchmark agnostic, BKI also seeks to achieve long-term capital growth. The Company has a commitment to diversification achieved by holding a portfolio of 45 to 60 well-managed and dividend paying companies across a variety of industries.
- Lonsec considers the Company's approach to impart it with a core investment style with an income bias. This style, along with the focus on fully franked dividend growth, leads Lonsec to expect BKI to deliver outperformance in down markets. Conversely, Lonsec would expect BKI to underperform in the latter stages of a bull market.
- BKI became externally managed by Contact Asset Management ('Contact' or 'the Manager') following a decision made by its Board of Directors ('BOD') in November 2016 to externalise the investment management of the Company. Previously, BKI had been internally-managed. The appointment is governed by an Investment Management Agreement ('IMA') with a term of ten years; an initial five-year term followed by an automatic five-year roll-over if there is no share-holder vote requisitioned. The Management Expense Ratio ('MER') under the IMA is 0.1% of total assets and there is no performance fee. The rationale behind externalising the investment management was mainly to protect the Company's low MER which Lonsec accepts.
- Contact is a new investment management firm founded by previous BKI CEO, Tom Millner, and Portfolio Manager, Will Culbert. Millner and Culbert hold 80% of the equity while Washington H Soul Pattinson ('WHSP') holds the remaining 20%. Lonsec notes that Contact is a related-party entity to BKI as both Tom Millner and long-standing BKI Chair Robert Millner are directors and shareholders of WHSP.
- As with many longer-standing LICs, BKI has been involved in a number of mergers and acquisitions since its inception in 2003. BKI itself was the result of the decision by Brickworks to list its investment portfolio on the ASX. Since then, BKI has merged with the WHSP-affiliated Pacific Strategic Investments Ltd in 2004 and the Huntley Investment Company Ltd in 2007. As well, BKI has an on-going program of merging with unlisted family-owned investment companies and has entered into five such deals at at August 2018. Lonsec notes that no such deals were executed into financial year of 2017-2018.
- BKI's portfolio turnover is expected by Lonsec to be very low (<10% p.a. of gross assets) which is due to its investment philosophy but also for tax reasons as low turnover is one of the tests the Company has to meet to maintain its 'capital account' election. This allows it to pass on capital gains tax concessions to its shareholders in the form of 'LIC capital gain dividends'. Lonsec expects BKI to generate the majority of its income from harvesting dividends and distributions received from its share portfolio.
- Lonsec notes that Contact's annual management fee is 0.1% of the Total Asset base of the Company (\$1.2bn as at 31 August 2018). This is expected to translate into a MER, which is measured against Net Assets, of 0.16% going forward. Being closed-ended and with the Contact fee its largest expense, this should mean that BKI incurs a relatively fixed level of operating expenses ('opex') going forward. Lonsec notes that cost control has been usually good with one-off exceptions, with BKI incurring opex of \$1.8m in FY18 which was higher than \$1.5m in FY17. 2017 benefited from the non-cash reversal of accrued employee incentives following the outsourcing of the investment management function.
- Lonsec notes that BKI's MER compares very favourably to other externally-managed LICs, ETFs and managed funds in the Lonsec peer group that provide a similar broad-based exposure to Australian equities. However, Lonsec observes that there are a number of well-established Australian equities focused LICs with mainly internally-managed structures that have similar fee structures; typically, these tend to have a similar high level of assets.
- A key risk for investors in any LIC is the possibility for such structures to trade at a substantial discount to NAV for lengthy periods of time. Lonsec considers that while trading at such a discount is a risk for BKI, it is less of a risk relative to many smaller LIC peers. BKI is somewhat shielded due to its relatively

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larger market cap (+\$1bn), reasonable liquidity, 17,000 shareholders and a solid and lengthy track record of paying fully-franked dividends.

- Lonsec notes that the BKI BOD continues to pursue various capital management initiatives. In FY18, BKI pursued a successful 1:15 non-renounceable pro-rata Entitlement Offer ('EO'), Shortfall Offer and General Offer in May and June 2018. EO and Shortfall Offer raised \$50m at \$1.50, a 2% discount to the share price before the Record Date (14 May 2018) and approximately 4.5% discount to the 30 April 2018 pre-tax NTA for BKI (\$1.57). The General offer, which closed on 14th June, raised approximately \$104.5m. Furthermore, in-line with BKI's Dividend Re-investment Plan ('DRP') Policy, a DRP has also been announced in August 2018 following the declaration of the final dividend. The DRP has been priced at \$1.55, the 5-day VWAP. Lonsec is pleased to note that the DRP is not priced at a discount to VWAP as this ensures that investors who do not subscribe to the DRP are not unnecessarily diluted. Lonsec considers the BOD to have a sound track record in terms of capital management.

## Using this Company

**This is General Advice only and should be read in conjunction with the Disclaimer, Disclosure and Warning on the final page.**

- BKI is subject to equity market risks and movements (both positive and negative) in the prices of the underlying securities in its portfolio. Potential investors should therefore be aware of, and comfortable with, the potential for it to experience periods of negative absolute returns which may result in capital losses being incurred on their investment. Lonsec recommends advisors consult the Lonsec Risk Profile Review and/or the Lonsec Risk Profile Definitions document(s) for guidance on appropriate asset allocations to Australian Equity within a diversified investment portfolio.

### Suggested Lonsec risk profile suitability

SECURE DEFENSIVE CONSERVATIVE BALANCED GROWTH HIGH GROWTH



For guidance on appropriate asset allocations and risk profiles, refer to the latest Lonsec Strategic Asset Allocation Review and Risk Profile Definitions on our website.

## Changes Since Previous Lonsec Review

- MER has increased from 0.14% in FY2017 to 0.16% in FY2018.
- In FY18, BKI pursued various capital management strategies, which include DRP at \$1.55 and a successful 1:15 non-renounceable pro-rata EO, Shortfall and General Offer in May and June 2018. This increased BKI's market Cap from \$1 billion in FY17 to \$1.12 billion in FY18.

## Lonsec Opinion of this Company

### Board of directors

- BKI's BOD consists of four members. Lonsec considers it to be very experienced but less diverse relative to some of its LIC peers. The BOD has good tenure at BKI with three of the four directors having joined at inception in 2003 and the fourth having joined in 2009. While noting the benefits of such stability, Lonsec considers succession planning to be an area of risk for investors due to such a high proportion of long-serving directors.
- BKI's BOD of four has two members designated as 'independent' by the Company. The 'independent', non-executive directors are David Hall and Ian Huntley. Lonsec notes that BKI's Chair is also not independent. It is considered 'best practice' by Lonsec for the BOD of a LIC to have a majority of 'independent' Directors and also an independent Chair as per the ASX listing rules. Lonsec notes that BKI's overall board structure does not have majority of its Board and Chair as 'independent'. Lonsec expects BKI to be able to attract talented independent directors as the need arises but notes that this is untested in recent times.
- A distinguishing feature of the Company is that a BOD sub-committee, the Investment Committee ('IC'), approves all changes proposed to its share portfolio. The IC is chaired by BKI's Chair of its BOD, Robert Millner, and also includes long-standing Non-Executive Directors ('NED') Huntley and Alexander Payne. It is rounded out by key Contact investment executives Tom Millner and Will Culbert.
- Lonsec considers the BKI directors on the IC to demonstrate strong investment experience. Chair Robert Millner has been in his role since 2003 and has extensive management and public company experience. Outside of BKI, he is also currently the Chair of listed entities WHSP, Brickworks ('BKW') and New Hope ('NHC') as well as being a non-executive director of TPG Telecom ('TPG'), and Australian Pharmaceutical Industries ('API'). He is also the Chair of Milton ('MLT') which is also an ASX-listed LIC.
- Payne has similar tenure and experience, having also been a member of the BOD since 2003 and having previously been the CFO of BKW. While not having the same tenure, Huntley has an extensive track record in business, having founded the 'Your Money Weekly' newsletter which he sold to Morningstar in 2006. He joined the BOD and IC as a NED in 2009 following the take-over of the Huntley Investment Company. Importantly, Lonsec notes that the majority of the IC have +15 years tenure at BKI. Lonsec is a firm believer that extensive co-tenure is a critical determinant in cohesive decision making in such structures.
- As well as the IC, the BOD is further supported by three other sub-committees being the Nomination, Remuneration and Audit Committees. Pleasingly, the Audit Committee is chaired by Hall, NED, who is the only member of the BOD not on the IC. Hall has held this role since joining the BOD in 2003. He has the appropriate experience to hold this key post. Lonsec notes that Payne is the Chair of the Remuneration Committee.

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- Lonsec has assessed BKI to have a high level of related-party risk. This stems from a number of sources. The first is due to BKI having a number of current shareholdings in the entities for which the Chair of both the BOD and IC, Robert Millner, is either the Chair or a director. This includes MLT, BKW, NHC and TPG. Lonsec also notes that Tom Millner is also a current director for WHSP.
- Lonsec notes that BKI has also entered into service agreements with a number of related-party entities. This includes Contact, which is owned 20% by WHSP. Additionally, BKI appointed Pitt Capital partners, a related-party entity, as financial advisor for recent Entitlement Offer. Lastly, the Corporate and Administrative Services Pty Ltd, a related-party entity, provides administrative, company secretarial and accounting services to BKI. Both are WHSP-owned entities.
- Having highlighted the risk, Lonsec is pleased to note that the Company has firm procedures in place to handle such conflicts. This includes the hard rule that no director or representative of Contact can be present in an IC meeting when any of his related party stocks are up for discussion. Also, the recent negotiations between Contact and BKI regarding the IMA were handled for BKI by the independent NED's Huntley and Hall. They made the recommendation to the BOD.

### People and resources - Investment manager

- Lonsec notes that Contact is the sole current provider of investment management services to BKI. Contact was formed in late 2016 (by Tom Millner and Will Culbert, in partnership with WHSP) to provide investment services to BKI. It has also subsequently brought an additional LIC IPO to market (URB Investments Ltd). While Contact does not have any direct reliance on WHSP, its related-party entities do provide back-office and operational support at market rates. Lonsec views the relationship with WHSP as a positive for both Contact and BKI and notes the similarities in the philosophies of both organisations.
- Lonsec notes that Contact has appointed its key investment executives (Tom Millner and Culbert) as the co-Portfolio Managers ('co-PM') for BKI. Tom Millner has over 17 years investment and portfolio management experience. Prior to establishing Contact, he was CEO of BKI (from 2008 to 2016) and has also been an investment analyst and portfolio manager with Souls Funds Management. Culbert also has a long-term investment track record, with 19 years of funds management experience in Australia and the UK. Culbert was portfolio manager for BKI for three years before co-founding Contact in 2016. Prior to this, he spent 11 years at Invesco Asset Management as an equity analyst and portfolio manager. Lonsec considers both to be experienced portfolio managers and highlights the long-term track record of Tom Millner, in particular, at BKI.
- Lonsec considers Contact's investment team to be small versus many peers, having only four members. Tom Millner and Culbert are assisted by two junior analysts, Rahul Tamilarasan and Jovana Gagic, who both joined in 2017 from EY and Pitcher Partners respectively. While Contact is looking to

expand the team in-line with its ambition to create a stable of LICs, it is likely that this will take some time and be linked to asset growth. However, Lonsec notes that outside of investment tasks, Contact runs a largely outsourced model and has heavily invested in automating its investment process. It also has the support of BKI's experienced IC of which both Tom Millner and Culbert are also members. Nonetheless, resourcing of the investment team will form a critical part of Lonsec's future reviews.

- Key person risk in Tom Millner and Culbert is considered by Lonsec to be high. However, given the equity held by both in the business is in the early stage of its life-cycle, the probability of either departing the Manager is considered low. Lonsec also notes that both Tom and Robert Millner have a strong family connection and background with both WHSP and BKI and are also substantial shareholders in both.
- The team's alignment with investor outcomes is also considered to be strong, particularly given the Manager is in its start-up phase where additional fund flow tends to be dependent on positive performance outcomes. As mentioned, Tom Millner also has a significant direct investment in BKI along with his family.

### Research and portfolio construction

- Lonsec considers BKI to have a logical and repeatable investment process that is closely aligned with its long-term and low turnover approach to investing. BKI uses a mix of both quantitative and qualitative techniques to select stocks in a benchmark unaware manner. The focus is on identifying the 'bottom-up' fundamentals of an individual company that make it a solid, dividend paying opportunity. Limited consideration is given to 'top-down' factors.
- As with other more 'buy and hold' focused LICs, Lonsec considers BKI's focus on sustainable dividend growth and LIC tax rules to mean that the research process is more focused on the maintenance of its stock portfolio and the identification of potential 'torpedo' stocks both from a capital preservation and a dividend sustainability perspective. This is different from many other 'bottom-up' research processes which seeks to re-generate an equity portfolio from time-to-time based on the opportunity set of best stock ideas. Having highlighted this, Lonsec notes that BKI continues to add a select number of new stocks to the portfolio on an on-going basis.
- In terms of the fundamentals that it focuses on, Lonsec notes that BKI's process is built around five key factors that it considers to be the most important in picking stocks that align best with its investment objectives. These include income, principal activity, debt levels, management/Board and earnings/valuation. As BKI is 'benchmark unaware', it does not have any stock or sector constraints. Lonsec agrees that these are likely to aid BKI in meeting its investment objectives.
- A criticism of Lonsec is that with a smaller team and between 45 to 60 stocks to maintain research coverage, the Company's ability to identify new ideas could be somewhat curtailed due to resourcing pressures. This is despite the idea flow which originates from the investment team and members of the IC. Lonsec considers this to potentially lead to a

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lack of suitable replacement stocks being identified and analyst potentially 'sitting on their hands' rather than making proactive sell recommendations. Lonsec acknowledges that Contact is trying to address this issue by using a systematic screen on Bloomberg to filter stocks by yield and PE multiple to aid with idea generation, however Lonsec would be seeking active analyst involvement to gain a greater conviction in the research process.

- Lonsec believes that there is no substitute for in-depth 'ground work' and as such is pleased with the Manager's extensive company visitation program. Over the past one year, 100 one-on-one company meetings have been conducted along with one overseas meeting. Lonsec pleasingly notes that hiring of junior analysts has freed up some time for Tom Millner and Will Culbert to focus on main investment tasks and company meetings, while not being distracted by dealing and administration tasks related to portfolio management.
- Lonsec notes that BKI's IC has ultimate responsibility for all investment decisions made. As previously discussed, the IC consists of three BKI directors (Robert Millner, Huntley and Payne) and the co-PMs. Lonsec notes that the co-PMs present formal 'Stock Review & Analysis' papers to the IC via a standardised template. This paper presents the Contact investment thesis on stocks via 105 separate questions grouped into broader categories, including Business, Customers, Industry, Management, Income/Dividends, Financials, Leverage and Valuation. This leads to a formal recommendation that must be ratified by the IC. Lonsec is pleased to note that standardised template makes it easy for the research process to be consistently applied.
- However, a common criticism of Lonsec of such committee structures is that they can dilute accountability for portfolio outcomes. Lonsec also notes that the current structure of the IC, i.e. having two Contact executives on the IC, is still relatively untested. However, Lonsec notes that the BKI NEDs have all been on the IC since 2009 and have extensive investment industry experience. Lonsec has a high regard for the track record of these members. Also, Tom Millner has previously been on the IC (as BKI's CEO) since 2008. Such extensive co-tenure is a critical factor in the efficacy and efficiency of such a decision-making structure.
- Lonsec notes that the BKI IC met on 15 occasions in 2018 and expects the frequency of IC meetings to be similar going forward. Lonsec notes that other LICs it covers with IC structures have tended to meet more frequently. While noting the low turnover approach of BKI, Lonsec acknowledges the potential for portfolio issues to drift. However, Lonsec notes that the IC is flexible enough to meet outside of this formal cycle to consider any recommendations that may require a prompt response.
- Lonsec highlights that outside of a commitment to diversification, portfolio construction for BKI is more 'art' than 'science'. Rather than critically evaluating its pool of stock ideas for potential portfolio inclusion, BKI has a very long-dated 'buy and hold' strategy which means that the portfolio tends to be relatively static when measured from period-to-period.

- Portfolio construction is also tempered by BKI's requirement to continue its capital account election which allows it to pass on CGT concessions to its shareholders. This election is dependent on BKI continuing to pass a number of ATO tests including portfolio turnover being below 10%. In Lonsec's view, these competing factors could potentially lead to BKI having lower 'sell discipline' on valuation grounds than competing strategies in the market.

### Risk management

- Lonsec notes that the Company has a separate and suitably experienced BOD that provides it with governance oversight. The BOD's role is as defined by BKI's Board Charter which stipulates that its primary purpose is to oversee the activities and performance management of the Company.
- In terms of its supervisory role, this includes the BOD providing oversight of Contact's performance and succession plans, monitoring of the investment portfolio performance and ratifying all portfolio transactions.
- Lonsec is pleased to highlight that the BOD has delegated much of its risk management oversight to the Audit Committee ('AC'), believing this design to be important in ensuring appropriate segregation of duties. The AC is tasked with reviewing the risk management framework that has been set for BKI among other tasks.
- Lonsec notes that BKI is 'benchmark unaware' and has a strong focus on fully franked dividend growth and long-term capital growth. Hence Lonsec considers the risk for the Company to be one of income and capital preservation. Lonsec considers BKI's investment philosophy and maintenance of the 'bottom-up' investment thesis supporting its portfolio to be critical in ensuring that risk management is embedded within its investment process and focused on these risks.
- Lonsec notes the Company's portfolio construction process to be relatively unconstrained outside of a broad commitment to diversification. Lonsec notes that there are no stock or sector limits in place. Hence, the risk exists that BKI can expose shareholders to significant idiosyncratic stock or thematic risks with these not being actively monitored due to the lack of investment grade risk management systems.
- Lonsec notes that BKI does not have access to risk management systems that are typically used by managers in Lonsec's universe to provide reporting on potential risks within equity portfolios.

### Funds under management

- As at 30 June 2018, BKI's Australian equities portfolio had a mark-to-market valuation of \$994m. At these levels, BKI is a small-to-mid sized manager within Lonsec's wider Australian equities peer group. However, Lonsec acknowledges that BKI is an 'all cap' strategy.
- BKI does not have a formal policy on an appropriate capacity limit for its stock portfolio. Lonsec notes that by virtue of its closed-end structure, future growth in the portfolio size will mostly be driven by performance rather than future inflows. The active DRP and capital management programs in place will

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also be an incremental driver of portfolio growth over time. Lonsec notes that BKI grew its FUM from \$1 billion in FY2017 to \$1.12 billion in FY2018 via a share purchase plan (SPP).

- At its current size, Lonsec does not consider BKI to have any capacity concerns. While it does have some large active weights in some mid cap names, the average position it has in these names is constrained to a degree by its natural diversification. Nonetheless, Lonsec would welcome any efforts by the Company to formally incorporate such studies into its risk management processes.

### Performance

- BKI has been listed since 2003 and has a substantial track record in the market. BKI's investment objectives are relatively simple, seeking primarily to grow its absolute level of fully franked ('ff') dividends over the long-term while also providing capital growth. In terms of its dividends, Lonsec observes that BKI has been able to grow the absolute level of its dividends over the last five years; it paid dividends of 6.7c ff per share in FY13 versus 7.3c ff in FY18. The Company has also demonstrated capital growth over the longer term, delivering a total shareholder return (100% franked) of 10.3% p.a. over the fourteen-year period to 30 September 2018. Hence, Lonsec considers BKI to have demonstrated reasonable success in meeting its investment objectives across an investment cycle.
- Lonsec considers BKI's demonstrable track record in growing both its dividends and investors capital over the longer-term to be a major determinant in it having such a loyal following from its shareholders. Lonsec also considers such consistency to be a key predictor of whether a LIC will trade in a closer band to its NAV over-time. Lonsec notes that BKI's share price has traded in a close 5% to 5% band to its NAV over the five-year period
- BKI delivered a mediocre full-year result as at 30 June 2018 (FY18), with net profit declining 1.4% on the prior corresponding period ('pcp') to \$45.01m and Earnings per Share (EPS) declining 4.5% to 7.23 cents. This decline in profitability led to this year's Dividend per Share (DPS) to increase marginally by 0.3% to 7.325 cents. The profit declined mainly due to the decrease in special investment revenue which declined by a very strong 80% on the pcp to \$0.8m.
- In line with the recent results, BKI has spent the majority of the past four months trading at a discount to its NAV. However, as of 31 of August 2018, the post-tax discount was 0.65%.
- BKI's underweight positions in top 20 names (such as CSL, BHP and RIO) along with royal commission effects in the banking sector and eroding NBN margins in the Telco sector (TLS) has seen its portfolio shrink by 1% from the pcp to \$994m.
- In terms of benchmark relativities, based on total shareholder return, BKI has underperformed the S&P/ASX 300 Acc. Index over ten and fourteen-years to 30 September 2018. Over fourteen-years, BKI returned 8.1% p.a. and underperformed by 0.3% p.a., while over ten-years it returned 6.9% p.a. underperforming benchmark by 0.8% p.a. The five and one-year performance numbers have been

more challenging, with BKI underperforming by 3.7% p.a and 16.6% p.a. respectively. The recent underperformance can also be contributed to the tough environment for 'yield' focused strategies. Given the very competitive MER (0.16% p.a.), Lonsec considers BKI's 14 year total shareholder return (100% franked) of 10.3% p.a. to be a good result for investors, but would be seeking improving short term performance over three and five years to justify its value to shareholders.

### Overall

- Lonsec has maintained the '**Recommended**' rating for BKI following the 2018 review. Lonsec's rating is supported by BKI's long-term track record of providing investors with both dividend and capital appreciation at an attractively priced MER of 0.16%. Lonsec also acknowledges the highly experienced and long-standing Board and Investment Committee of BKI, with notable co-tenure.
- However, Lonsec notes the potential for diminished accountability with co-PM structure. Lonsec is also cautious of BKI's low turnover philosophy leading to potential diminished sell discipline on valuation grounds. Furthermore, high related-party risk with BKI's portfolio holding stocks in a number of listed entities associated with BKI's Chair, Robert Millner, is concerning. Going forward, Lonsec would be seeking an improvement in relative short-term performance to maintain its conviction.

## People and Resources

### Corporate overview

- Contact is a new investment management firm founded by previous BKI CEO, Tom Millner, and Portfolio Manager, Will Culbert. Millner and Culbert hold 80% of the equity while Washington H Soul Pattinson ('WHSP') holds the remaining 20%. Lonsec notes that Contact is a related-party entity to BKI as both Tom Millner and long-standing BKI Chair Robert Millner are directors and shareholders of WHSP.

The BKI of today has been shaped by a number of significant transactions since it first listed in 2003. These have been listed in the table below. These transactions have been instrumental in growing the Company to its current market capitalisation and broad shareholder base.

### Key events

2003	INITIAL PUBLIC OFFER OF THE BRICKWORKS PORTFOLIO
2004	ALL SCRIP MERGER WITH PACIFIC STRATEGIC INVESTMENTS (ON 2-FOR-7 BASIS)
2007	TAKE-OVER OF HUNTLEY INVESTMENT COMPANY
2007	1-FOR-5 RENOUNCEABLE RIGHTS ISSUE AT \$1.35
2013	1:15 NON-RENOUNCEABLE RIGHTS ISSUE AT \$1.48
2016 - 2017	SERIES OF TRANSACTIONS WITH 5 UNLISTED FAMILY INVESTMENT COMPANIES
2018	1:15 NON-RENOUNCEABLE RIGHTS ISSUE AT \$1.50

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## Size and experience - Board of directors

NAME	POSITION	YEAR JOINED
ROBERT MILLNER	NON-EXECUTIVE CHAIR	2003
DAVID HALL	INDEPENDENT NON-EXECUTIVE DIRECTOR	2003
IAN HUNTLEY	INDEPENDENT NON-EXECUTIVE DIRECTOR	2009
ALEXANDER PAYNE	NON-EXECUTIVE DIRECTOR	2003

### Robert Millner, Non-executive Chair

Millner was first appointed as Chair of BKI in 2003. He has extensive management and investment industry experience and is also the Chair/director of a number of listed entities. He has long-standing experience with LICs and is also the Chair of MLT. Millner is the Chair of BKI's Investment Committee and is a member of the Remuneration and Nomination Committees. He is also a large shareholder in the Company.

### David Hall, Independent Non-executive Director

Hall is a long-standing independent NED of BKI having first joined in 2003. He is a Chartered Accountant with over 31 years of experience in corporate management, finance and Directorships. Hall is the Chair of the Audit Committee and a member of the Remuneration Committee. He is also a large shareholder in the Company.

### Ian Huntley, Independent Non-executive Director

Huntley is the most recent addition to the BOD, having been appointed as a NED in 2009. He has a long-term track record in business and investment markets, having founded the 'Your Money Weekly' newsletter which he sold to Morningstar in 2006. Huntley is a member of the Investment, Remuneration, Audit and Nomination Committees. He is also a substantial shareholder in the Company, a stake which he largely acquired during the Huntley Investment Company take-over.

### Alexander Payne, Non-executive Director

Payne is also a foundation NED, having also joined in 2003. Payne is the former long-standing CFO of Brickworks. Payne is the Chair of the Remuneration Committee and is a member of the Audit, Investment and Nomination Committees. He is also a shareholder in the Company.

## Board remuneration

NED (including the Chair) remuneration in aggregate must not exceed a limit that has been approved by shareholders via a formal vote. This maximum aggregate limit is \$300,000 p.a. and it can only be increased via an ordinary share-holder resolution. In terms of how this is allocated to individual directors, in 2018 Payne and Huntley each received \$46k, Hall received \$56k and Robert Millner as Chair received \$73k. In aggregate, the four NEDs received \$222k which is well below the \$300k ceiling. This is slightly up from 2017, where \$217k was incurred by BKI on NED fees.

## Size and experience - Investment team

NAME	POSITION	EXPERIENCE INDUSTRY / FIRM
ROBERT MILLNER	CHAIR	34 / 2
TOM MILLNER	PORTFOLIO MANAGER	17 / 2
WILL CULBERT	PORTFOLIO MANAGER	20 / 2
RAHUL TAMILARASAN	INVESTMENT ANALYST	3 / 1
JOVANA GAGIC	INVESTMENT ANALYST	4 / 1
JAMIE PINTO	COMPANY SECRETARY	22 / 2

- Contact has appointed Tom Millner and Will Culbert as the co-Portfolio Managers' of BKI. Both Portfolio Managers have over sixteen years of relevant portfolio management and investment industry experience. Prior to Contact, Tom Millner was BKI's CEO for nine years and Culbert was the Portfolio Manager for BKI for three years before Contact's inception. Prior to BKI, Culbert held senior investment roles at Invesco for eleven years.
- Contact's team is rounded out by two recent hires. The two investment analysts, Rahul Tamilarasan and Jovana Gagic, have been with Contact since 2017. Tamilarasan has joined from E&Y, where he was placed in the financial services assurance division for two years. Gagic spent three years at Pitcher Partners as an accountant and senior auditor prior to joining Contact.

## Investment team remuneration

- Contact receives a fixed investment management fee of 0.1% of total assets and there is no performance fees. Tom Millner and Culbert own 80% of Contact. Tom Millner is also large share-holder in BKI.
- Remuneration of Contact's investment analysts comprises of Base salary (inclusive of superannuation) and Long Term Incentive Scheme (LTI). LTI is calculated on 20% of the base salary and vested in the analyst at the end of the first year of employment, and each subsequent year. BKI and URB ordinary shares (50/50), bought on market by Contact, forms the paid component for LTI.

## Research Approach

### Overview

RESEARCH PHILOSOPHY	CORE
NO. STOCKS IN UNIVERSE	300
NO. STOCKS FULLY MODELED / RESEARCHED	100
RESEARCH INPUTS	COMPANY VISITATION PROGRAM, PROPRIETARY FUNDAMENTAL 'BOTTOM-UP' ANALYST RESEARCH
BROKER RESEARCH	IDEA GENERATION
VALUATION OVERVIEW	EARNINGS MULTIPLES (PE, EV/EBITDA)
QUALITATIVE FACTORS	INCOME, PRINCIPAL ACTIVITY, DEBT LEVEL, MANAGEMENT / BOARD, EARNINGS / VALUATION
COMPANY VISITS	100+
BOTTOM UP	100%

### Idea Generation

While BKI has a very low turnover approach, new ideas will be added to the portfolio from time-to-time. These will typically be funded from the re-investment of capital gains or the proceeds from SPP/DRP. In terms

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of such ideas, BKI is focused on identifying stocks using five basic fundamental factors as follows:

1. Income – dividend yield, franking credits and payout ratios;
2. Principal activity – sustainable business model, competitive advantage, barriers to entry;
3. Debt levels – gearing ratios, net interest coverage;
4. Management and Board – alignment, Board meeting attendance, creating share-holder wealth; and
5. Earnings and valuations – earnings profiles, PE multiples, EV/EBITDA multiples

### Bottom-up Process

Both new stock ideas and existing portfolio stocks are then subjected to a rigorous 'bottom-up' stock research process. This task is allocated to individual analysts along sector lines. Key research tasks include:

- Monitoring of company announcements;
- Attending company site visits and management presentations; and
- The maintenance of bespoke company models which assess the prospects for both earnings sustainability and dividend growth.

The Company's investment team also has access to Factset, Bloomberg and Iress to provide them with access to market data.

### Portfolio Construction

#### Overview

FUND BENCHMARK	S&P/ASX 300 ACC. INDEX
RETURN OBJECTIVE (INTERNAL)	CAPITAL GROWTH AND SUSTAINABLE FULLY FRANKED DIVIDEND GROWTH
RISK OBJECTIVE (INTERNAL)	NOT TARGETED
PORTFOLIO DECISIONS	INVESTMENT COMMITTEE
STOCK SELECTION	DIVIDEND FOCUSSED
TYPICAL NUMBER OF HOLDINGS	45 TO 60
MARKET CAPITALISATION BIAS	MID-TO-LARGE
EXPECTED PORTFOLIO TURNOVER	VERY LOW, LESS THAN 10% P.A.
% OF PORTFOLIO IN TOP 25 HOLDINGS	87%

BKI's portfolio construction process is broadly unconstrained outside of a commitment to appropriate stock and sector diversification. This approach is plausible given the very low turnover approach. The final portfolio weights arrived at are more 'art' than 'science' and take into consideration BKI's dividend objectives and the need to be low turnover. In terms of 'sell discipline', the Company will sell a position if its investment case is no longer valid. However, a stock simply trading above its intrinsic valuation is not considered a reason to sell.

#### Demarcation of Duties

The Company's co-Portfolio Managers and investment team are responsible for monitoring the existing stock portfolio and for making stock recommendations to the IC. The IC meets regularly (15 times in FY18) and will consider all such recommendations at these meetings for potential approval.

### Risk Management

#### Risk limits

INDEPENDENT RISK MONITORING	YES
STOCK	NIL
SECTOR	NIL
CASH	5 - 10%
TRACKING ERROR	NOT TARGETED

#### Risk monitoring

The primary risk management monitoring for BKI is performed by its BOD. The BOD has, in turn, delegated some of its oversight duties to the separate Audit Committee. As a listed entity, the Company also has to meet the ASX listing rules which is an additional oversight.

### Risks

#### Equity Market

Investments in equity markets are subject to numerous factors which may have an impact on the performance of an investment (both positive and negative). Unexpected changes in economic, technological, structural, regulatory or political conditions can have an impact on the returns of all investments within a particular market.

#### Investment

Being an LIC, its securities may trade on the ASX at a discount to its NAV for extended periods of time.

#### Related-party

BKI is an owner of positions in certain stocks where its independent directors are also influential directors. The risk here is that BKI is prevented from adding to these positions or trimming/exiting these positions due to such influences. BKI also has service provisions with some related-party entities. The risk is that these are not struck at arm's length terms.

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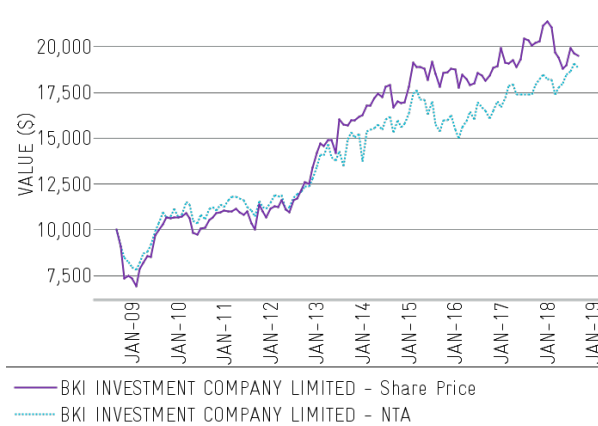
## Quantitative Performance Analysis - annualised after-fee % returns (at 30-9-2018)

### Performance metrics

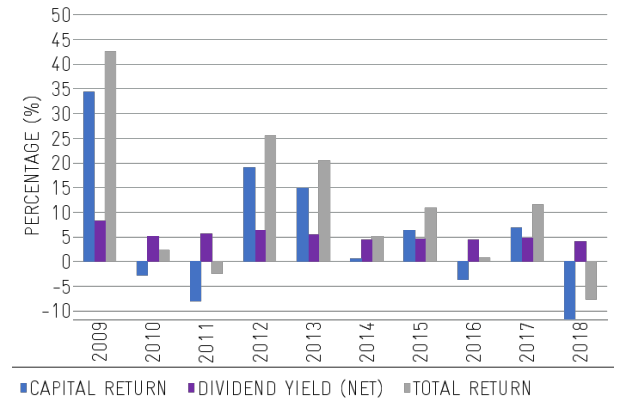
	1 YR	3 YR	5 YR	10 YR
TOTAL RETURN (% PA)	-2.60	3.14	4.46	6.91
STANDARD DEVIATION (% PA)	10.62	9.76	10.14	14.89
EXCESS RETURN (% PA)	-16.57	-8.97	-3.73	-0.83
WORST DRAWDOWN (%)	-12.00	-12.00	-12.00	-30.84
TIME TO RECOVERY (MTHS)	NR	NR	NR	7
TRACKING ERROR (% PA)	9.43	11.08	9.54	11.02

FUND: BKI INVESTMENT COMPANY LIMITED  
 BENCHMARK USED: S&P/ASX 200 TR INDEX AUD  
 TIME TO RECOVERY: NR - NOT RECOVERED, DASH - NO DRAWDOWN DURING PERIOD

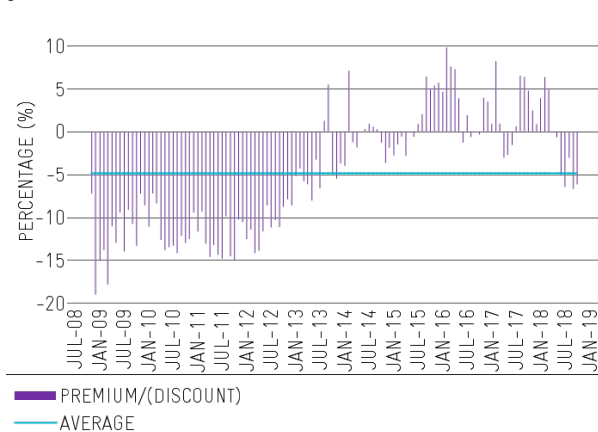
### Growth of \$10,000 over 10 years



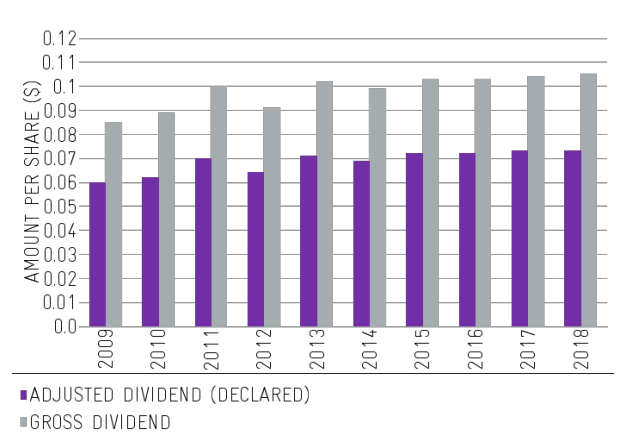
### Calendar Year Returns over 10 years



### Share Price Premium/Discount to NTA over 10 years



### Dividend Record over 10 years



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# BKI Investment Company Limited

## Glossary

[Click here for the glossary of terms.](#)

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