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BKI INVESTMENT COMPANY

ABN: 89 615 320 262

BKI INVESTMENT COMPANY LIMITED

QUARTERLY REPORT

Low Rates and the Chase for Yield

CONTACT ASSET MANAGEMENT

BKI is managed by Contact Asset Management
AFSL 494045

BKI Quarterly Report

Welcome to the 24th edition of the BKI Quarterly Report, prepared by Contact Asset Management ("Contact").

Around the world interest rates have been hitting record lows and in some regions such as Japan and the European Central Bank have turned negative. Australia is no exception to this trend. On 1 October 2019 the Reserve Bank of Australia (RBA) acted on weaker economic data with a 25 basis point cut to a record low of 0.75%. Following the further release of economic data, many commentators are now predicting another interest rate cut to 0.50% early in 2020 and possibly another cut to 0.25% by the middle of next year.

In this Quarterly Report, we:

- Focus on how a lower interest rate environment is impacting the savings rate of many individuals and the Australian equity market;
- Examine how we maintain value in the BKI portfolio within current market conditions to ensure we continue to pay Shareholders an attractive dividend each year; and
- Identify positive indicators including population growth, infrastructure spending and growth in superannuation that we believe will help BKI continually grow its revenue stream and in turn allow us to lift the dividends paid to Shareholders.

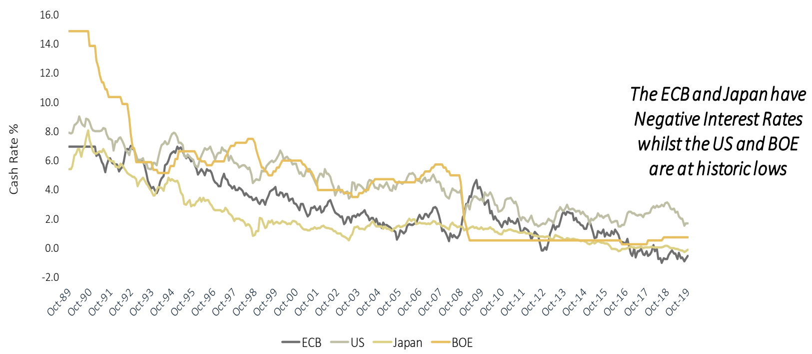
BKI's Objectives and Strategy

BKI's aim is to generate an increasing income stream for distribution to Shareholders in the form of fully franked dividends. As the Investment Manager of BKI, Contact is always seeking to find the highest quality businesses that continue to compound capital and can grow fully franked dividends through all cycles, especially in a lower interest rate environment.

As at 30 November 2019, using the FY2019 interim dividend of 3.625cps, FY2019 final dividend of 3.70cps and a share price of $1.64, the historical dividend yield is 4.5%. Including both special dividends which totalled 2.50cps, the historical BKI dividend yield increases to 6.0%. As at 30 November 2019, BKI generated a Total Shareholder Return ("TSR") including dividends of 21.8% over the last year and 10.0% per annum for 15 years.

Global Interest Rates

The race to the bottom has been a global phenomenon. In Australia, this concept has been foreign to us until recently, but there are millions of investors today who have to deal with a negative yield. Their future is all about the "Return of Capital", not "Return on Capital". Stop and pause to think about that for a moment. Many investors, retirees and pensioners are willing to accept a lower nominal return just to ensure their nest egg is there to draw down on during retirement. No-one in Australia wants to experience that scenario, but unfortunately for many individuals in Japan and Europe this is a reality.



Source: Contact Asset Management, Factset

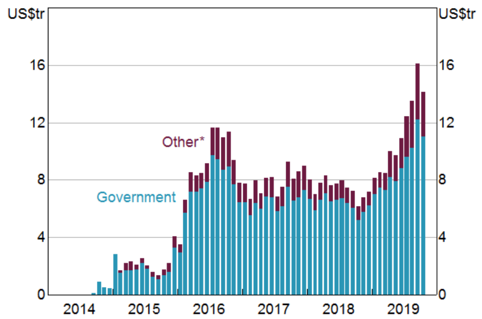
Negative Yields & Growth in Global Debt

One major consequence of low rates is the availability of low cost capital driving up both public and private debt. There is now an estimated US$14 trillion of bonds trading at negative yields around the world with a quarter of all government bonds globally now trading at negative yields.

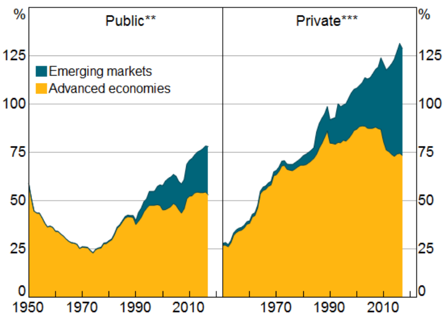
The Swiss Government for example can borrow for 30 years at an interest rate of negative 0.20%. Jyske Bank A/S, Denmark's third-largest bank announced on Monday 5 August 2019 that it was offering the world's first 10-year mortgage at a rate of negative 0.50%. While a negative interest rate makes it sound like borrowers will be paid to take out a mortgage rather than pay the bank interest, the reality is that once banking and transaction fees are added to the rate, it is expected the borrowers will end up owing capital on the loan. "It's an uncomfortable thought that there are investors who are willing to lend money for 30 years and get just 0.5% in return," Lise Nytoft Bergmann, Chief Analyst at Nordea's home finance unit in Denmark, told Bloomberg in August. "It shows how scared investors are of the current situation in the financial markets and that they expect it to take a very long time before things improve."

Seeing debt as a percentage of GDP rise, especially from the emerging markets is also something we are looking at closely.

US$14 trillion is now in negative territory



Debt as % of World GDP is at historic levels



Source: Contact Asset Management, RBA

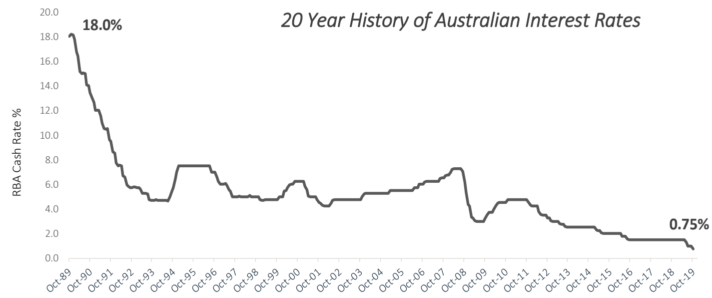
Australian Macro Concerns Lead to Lower Rates

Locally many negative indicators have pushed the RBA towards similar levels to other developed markets in recent times. In particular:

- Unemployment rates - a Definite uptick in unemployment and lower job ads[1];
- Lower levels of job security - a key indicator for banks when assessing home loans;
- Lower GDP growth - with pressure emerging from the drought and lower earnings from the resource sector[1];
- Weaker business conditions - NAB Business Survey shows business conditions trending lower[2];
- Weaker business confidence - below average trends in forward orders and capital expenditure[2];
- Tighter credit conditions - credit growth has slowed, driven by slower housing credit growth[3];
- Falling housing prices - declines in Australian real-estate values over 2019 are the ninth-largest on record; and
- Falling Australian Dollar – currency implications of not joining the rush to the bottom.

We believe the RBA will look to keep interest rates low for an extended period. In a speech delivered at this year's Sir Leslie Melville lecture on 29 October 2019, RBA Governor Philip Lowe said "Measures of inflation expectations suggest that inflation is expected to remain low for many years to come."

On 3 December 2019 the RBA left interest rates unchanged at 0.75%, with Governor Philip Lowe saying "Given these effects of lower interest rates and the long and variable lags in the transmission of monetary policy, the board decided to hold the cash rate steady at this meeting while it continues to monitor developments, including in the labour market."



Source: Contact Asset Management, Factset

He added that the economy appeared to have "reached a gentle turning point," and that there was hope of an increase in spending by consumers as property prices rebounded: "The low level of interest rates, recent tax cuts, ongoing spending on infrastructure, the upswing in housing prices and a brighter outlook for the resources sector should all support growth."

"[The low interest rate] has also boosted asset prices, which in time should lead to increased spending, including on residential construction. Lower mortgage rates are also boosting aggregate household disposable income, which, in time, will boost household spending."

[1] Contact Asset Management, RBA
[2] NAB Business Survey
[3] RBA, NAB, ABS, BIS Shrapnel, Abelson, Corelogic, Residex, Stapledon.

While it was a slightly more positive speech, most economic forecasters are still expecting another 0.25% cut in February 2020 and many expect that rates will be 0.25% by the middle of 2020. We continue to believe that rates could be lower for longer.

Valuations Have Changed

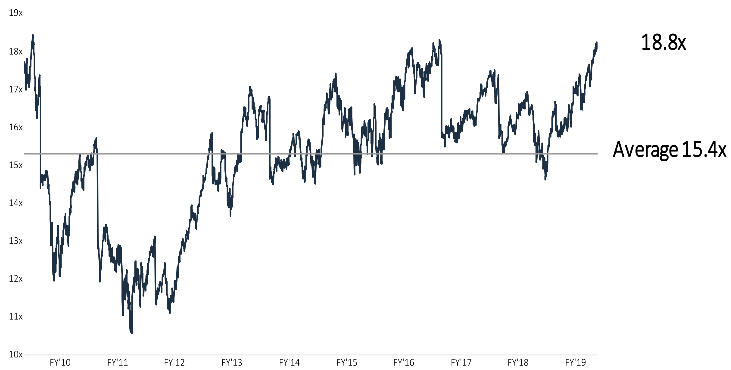
Falling rates are influencing market valuations and driving share prices higher as investors search for yield. We believe that falling rates added +1.6 points to the Australian Equity Price-to-Earnings ratio (P/E) multiple in FY2019. The market multiple of the S&P/ASX300 index grew from 15.9x to 17.5x also mirroring a similar effect in the US. We also believe that lower rates in the latter part of the 2019 calendar year have given another +1.3 points to the Australian Equity P/E multiple in FY2020 taking it to 18.8x. If we compare a P/E ratio of 18.8x with the current yield of term deposit rates that is less than 2% (the equivalent of a P/E of 50 times), we realise the stark difference in the valuation levels of these two asset classes.

		ROIC – Cost of Capital			
		4%	Falling Rates → **6%**	Falling Rates → 8%	Falling Rates → 10%
Earnings Growth	8%	27.2	32.3	36.2	40.0
	6%	15.9	17.5 →	18.8	20.1
	4%	12.8	13.5	14.0	15.5
	2%	11.4	11.6	11.8	12.0
		FY2018	FY2019	FY2020	FY2021

Source: Contact Asset Management, Bloomberg, Factset

Despite this, we remain cautious of the high multiple seen in today's market. It is no surprise that low term deposit rates have pushed investors into the market to look for yield, thus forcing prices and P/E multiples higher. The search for yield has driven strong index gains and the S&P/ASX300 Accumulation index is now up 26.0% for the year to 30 November 2019.

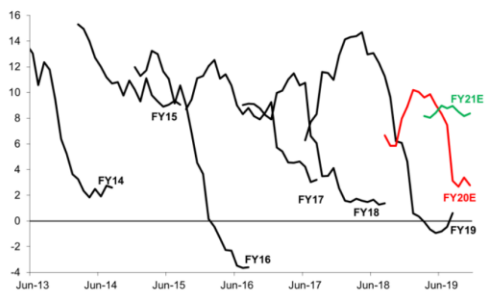
However, historically and especially over the last 10 years, 18.8x is a very high P/E multiple for the index as evident in the chart on the right.



Source: Contact Asset Management, Factset

These higher share prices place pressure on the forward earnings of companies. We are again wary of the market expectations of earnings for the year ahead. Very rarely does the market get the earnings per share forecasts right. As we can see in the charts below, there have been many years where analyst expectations for annual earnings growth for the industrials start at around 6%-10%, only to finish the year delivering around 2% growth. Earnings expectations for the banks have been even worse, with growth of 2%-4% expected and the banks actually delivering anywhere between 2% and negative 7% earnings growth. Curiously, lower interest driven market multiple expansion has broadly offset weaker earnings per share outcomes.

Declining EPS Forecasts – Industrials



Declining EPS Forecasts – Banks

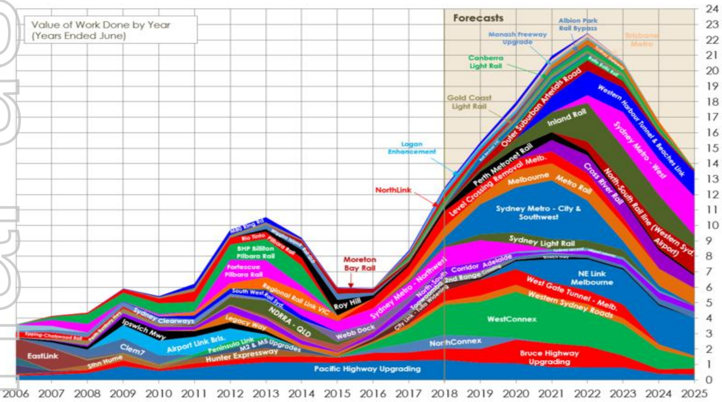
Source: Contact Asset Management, Macquarie Research, Bloomberg, Factset

Looking for Opportunities

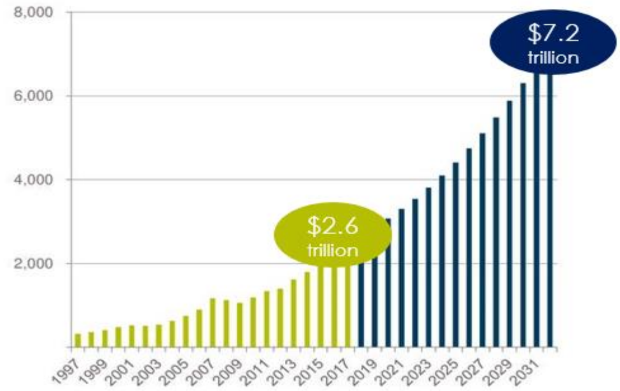
Despite there being many negative macro indicators, lower interest rates and extended short-term stock valuations, the beauty of equity markets is that they constantly display areas of inefficiency. A company that can be held in a portfolio for many years into the future can be displaying a full, efficient price today, but that does not mean the stock is priced correctly for future years and future growth. The longevity and duration of many of the companies held within the BKI portfolio is something we are very focused on and quite excited about. The long-term success of BKI will fundamentally be measured in the first instance by our portfolio holdings and their ability to grow their value over time through the compounding of their cash flows and the dividends they pay. To get this right requires a long-term view.

Notwithstanding the macro issues stated earlier, there are many parts of our market experiencing very positive tailwinds. Despite lower prices there is still a strong demand for our commodities, in particular iron ore, coal, oil and gas. Our dollar at current levels is positive for tourism and exporters. We have a stable government and companies continue to have the ability to attach franking credits to dividends declared and paid to Shareholders.

Forecast infrastructure work as at 30 June 2019



Australian Superannuation System Forecast ($b)



Source: Challenger 31 December 2017 Investor Presentation, Macromonitor, Australian Construction Outlook,

In infrastructure Australia's significant transformation is continuing thanks to Federal and State Government spending. Infrastructure spend is currently at levels never seen before and will continue for many years. This global trend, fuelled by significant population growth and urbanisation will benefit companies who have made long term infrastructure investments in industries including: Freight Road, Rail and Logistics Networks, Communications Networks and Exchanges and Hospitals and Age Care Facilities. Very low global interest rates certainly boosts these investments!

The growth in superannuation assets in Australia out to the year 2035, is also going to be substantial. From under $2.0 trillion in 2014, the Australian superannuation pool is expected to grow to over $7.2 trillion by 2035. It's well on the way with super assets totalling $2.9 trillion as at the end of June 2019, up 12% from $2.6 trillion at the end of March 2018. As at the end of the June 2019 quarter, over half of superannuation investments were invested in equities; Property and Infrastructure accounted for approximately 14%, while Fixed Income and Cash accounted for 32%.

It's becoming increasingly clear to us that despite low interest rates globally, positive trends in population growth, infrastructure spend and superannuation growth will continue to provide significant tailwinds for many of the stocks within the BKI portfolio for many years to come and in particular the stocks shown below.

Population Growth | *Infrastructure Spend* | *Growth in Superannuation*

Population Growth: regis healthcare, Ramsay Health Care (People caring for people), Sydney Airport, Woolworths (The fresh food people), Coles Group, Harvey Norman

Infrastructure Spend: Transurban, BHP, lendlease, CIMIC, reece, woodside, Brickworks Building Products

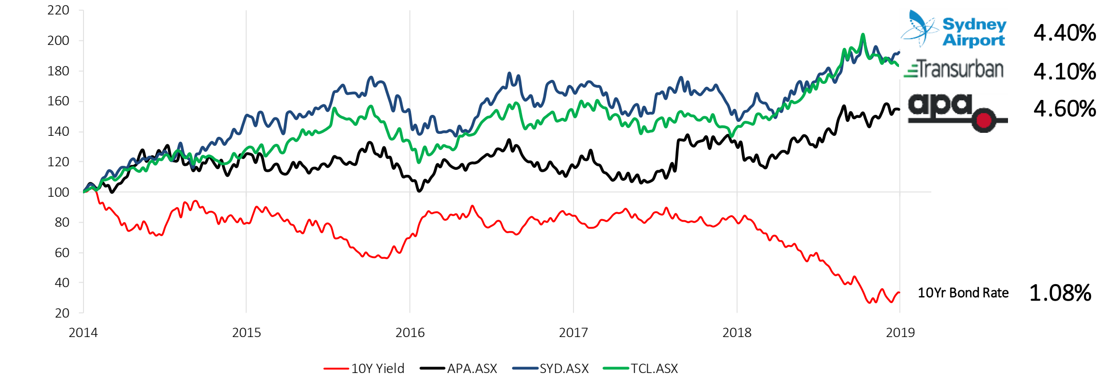
Growth in Superannuation: Magellan Financial Group Limited, Platinum Asset Management, Evans Dixon, Macquarie, Equity Trustees, CommonwealthBank

Source: Contact Asset Management

Yield Curve and Infrastructure Stocks

The global trend of declining interest rates and bond rates during 2019 has benefited infrastructure companies such as Transurban Group, Sydney Airport and APA Group. Investors have moved from products like the Australian 10 year bond (now yielding approximately 1.08%, having yielded over 5.50% some 10 years ago) into these names where the rates of return are higher.

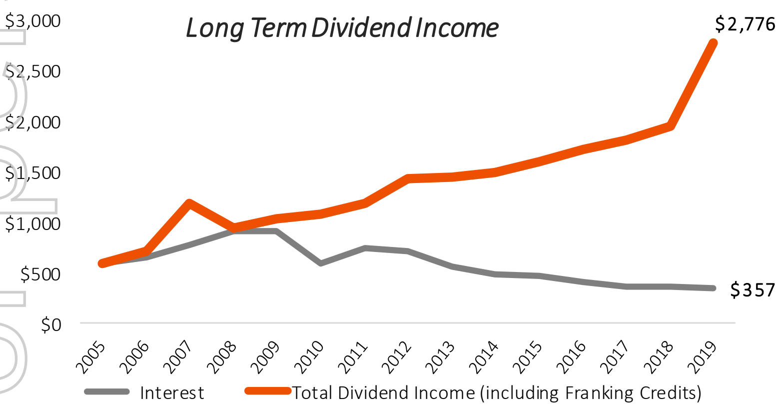
These large infrastructure companies have been able to refinance their debt facilities at very attractive pricing, strengthen their balance sheets for the future, build or invest into projects for future growth as well as lift distributions to Shareholders. We view these initiatives as positive for the future growth prospects of these companies.



Source: Contact Asset Management, Factset

Conclusion

With the RBA now having cut interest rates to a record low of 0.75%, we believe the low interest rate environment continues and could even trend lower. For us owning the highest quality businesses is where we believe the BKI portfolio will create the most value for Shareholders. Much of what the BKI Investment Committee and Contact does in assessing businesses is take a long term view and identify high quality businesses that that can continue to deliver high ROE and growing dividends. Owning the best companies not only has the ability to compound capital at a higher rate, it also protects the portfolio on the downside and will ensure we are in a strong position to continue to pay BKI Shareholders an attractive dividend.



In closing, the chart on the left highlights the opportunity we have already seen from receiving sound fully franked dividends in a low interest rate environment. We have shown this chart many times before at various presentations. An investor who spent the equivalent of $10,000 to purchase BKI shares upon listing in December 2003, would now be receiving fully franked dividends of $1,943pa. The franking credits enhance the income by a further $833, assuming a tax rate of 30%, giving total income of $2,776 for the year. The same investment in a term deposit (based on the cash rate + 0.50%) would have only earnt $357 last year with no franking credits.

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