Clime Capital Limited (ASX:CAM)

# Quarterly Report

June 2012

www.climecapital.com.au

Dear Fellow Shareholder,

Welcome to the Clime Capital Limited (CAM) Quarterly Report.

The June Quarter of 2011/12 was a poor one for the Australian equity market. However, as has often been the case over the last 45 months since the GFC lifted (March 2009) the portfolio of Clime Capital maintained its value and generated strong investment cash flows. Importantly, these cash flows support our quarterly franked dividends and provide cash for reinvestment by Clime so that compounding of investment returns can occur.

After the initial market surge in the six months following the G20 Meeting of March 2009, the Australian equity market has essentially oscillated between 4000 and 5000 on the All Ordinaries Index. In reality the market has gone nowhere and many major companies have seen their prices slashed in response to declining earnings and profitability. In the most recent quarter this trend appeared to accelerate and so it was important as a portfolio goal to avoid problems. The Clime investment approach, which focuses on sustainable "return on equity" and high yield has delivered on this goal.

In the past 12 months the overall market generated a negative return whilst Clime Capital was once again able to generate a positive return for shareholders and importantly increase the dividends paid to its shareholders. During a poor market dividends are important but when economic and profit recovery returns, and it will, it may be appropriate for Company to maintain or raise more equity to compound its returns for shareholders.

I raise the above commentary on capital to stimulate discussion and thought amongst our shareholders and broader investors. The Investment Managers of Clime have achieved good returns in a most difficult environment and I would suggest that they would do even better when a positive economic cycle returns.

I trust that you find that the commentary and review that follows is enlightening and informative.

Kind Regards,

**John Abernethy**
Chairman

In this issue

# Offer to shareholders

Clime Capital Limited ("Clime") offers investors the opportunity to invest in a value focused "closed end" Investment Company managed by a recognised top performing Australian Value Equity Manager - Clime Asset Management ("the Manager").

The Clime investment company structure offers a number of key advantages to investors.

These are:

- Clime (through its Manager's decisions) will not be a forced seller of securities in difficult times;
- Clime will not be forced buyers at inappropriate times; and
- Clime pays quarterly dividends to shareholders.

This allows Clime to focus on protecting and growing its capital over the longer term.

Clime invests in a diversified portfolio of Australian businesses, trusts and interest bearing securities.

Clime has a disciplined investment approach focused on the distinction between value and price. The allocation of investment capital into the market generally and stocks specifically is tempered by the Manager's continual macro-economic overlay. The company has the ability to hold elevated cash levels when market risks are considered to be elevated or value is not apparent. The Manager has the ability to look across listed asset classes to seek returns. This is a unique offering in an environment where many managers are often forced to be fully invested in one asset class with asset consultants dictating weightings.

Clime benefits from a strong and experienced team of value focused investment professionals. The Manager is the largest shareholder in Clime and thus its interests are strongly aligned with shareholders.

# Investment Objectives & Our Process

*"Clime's first preference is to deploy its capital into businesses that can self-fund their growth"*

The key objectives of Clime are:

- To preserve the capital of the company;
- To generate long term growth of capital and dividends without taking excessive risk.

The Manager seeks to achieve these objectives by purchasing the securities of companies that are understandable, that have honest and capable managers and are highly likely to generate superior returns over time. Securities will only be purchased when the price on offer is below the appraised value.

The investment approach is disciplined and transparent. The features of this approach are:

1. Securities are acquired in attractive companies when the market price on offer is at a discount to our assessment of value;
2. Positions are reduced or closed when the market price is well above the assessment of value;
3. A realistic requirement for required return is maintained so that the risk of the portfolio is properly balanced to achieve returns without risking capital;
4. Yield is sought to enhance portfolio returns through compounding; and
5. Cash will become an important asset of the portfolio when prices are expensive and value is not readily available in the market.

## *"**Price** is what we pay and **Value** is what we receive."*

The Manager is firmly of the view that price and value are different concepts. Price is what we pay and value is what we receive. While the share price is freely observable, the valuation of a company requires calculation. The investment process identifies companies that have attractive investment characteristics, applies a consistent valuation methodology, calculates a valuation for the company and identifies the companies whose share price is below our assessment of the company's value.

Clime's first preference is to deploy its capital into businesses that can self-fund their growth. These companies create value for owners by generating strong returns on equity with appropriate leverage for their business models. The profits generated by this group of businesses are best retained by the business so long as their managers can deploy retained earnings at similar "return on equity" levels. In cases where investee companies cannot redeploy retained earnings at attractive rates we look to their managers to rationally payout these profits to us as franked dividends. This allows us to make the capital allocation decision.

The Manager continually assesses investee businesses with reference to the demonstrated returns on incremental capital and the outlook for future returns on capital. Low returns on equity are not attractive nor are businesses that continually ask shareholders for additional capital.

Clime does not have current borrowings or the intention to take on debt.

# Performance

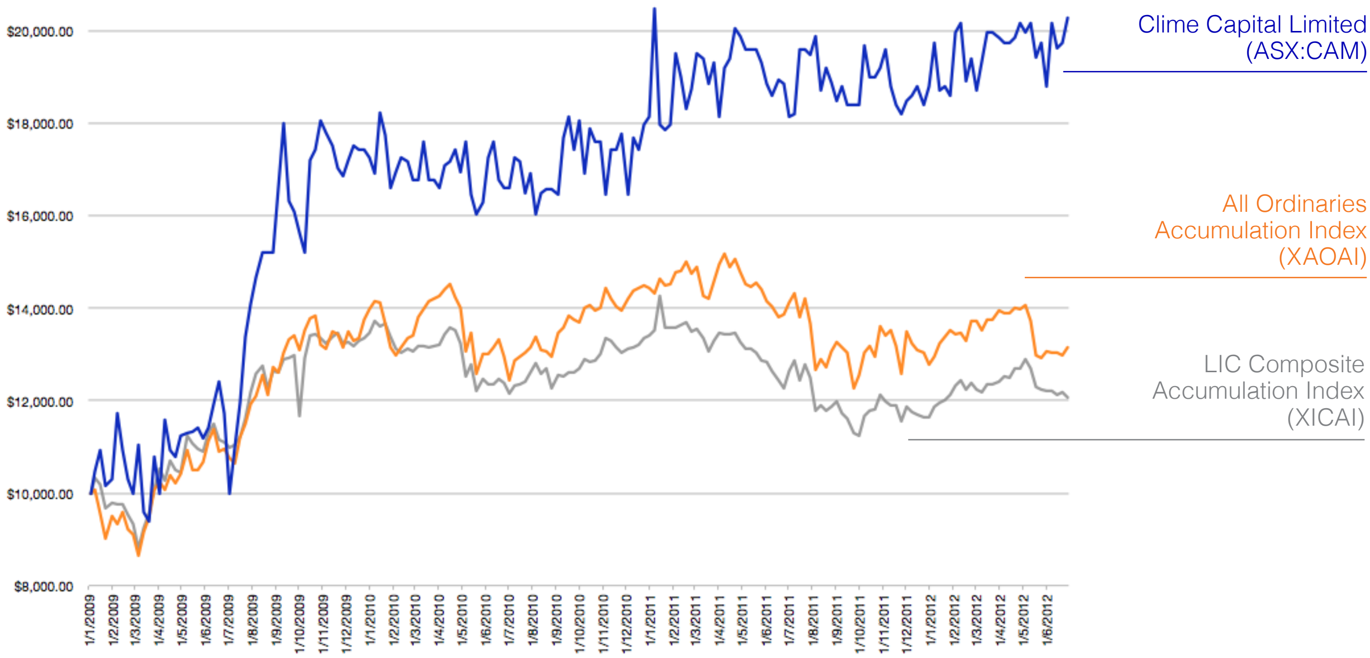
*We are pleased with the medium term performance of the portfolio. The 3.5 year returns of Clime, under current management, have exceeded both market returns and those of most other LIC managers.*

| As at 31 March 2012 | 1 Year | Since January 2009 |
|---|---|---|
| Clime Capital Total Shareholder Returns | 11.8% | 22.4% p.a. |
| LIC Composite Accumulation Index | -4.4% | 5.5% p.a. |
| All Ordinaries Accumulation Index | -7.0% | 8.1% p.a. |

More recently and despite market volatility, the Manager has ensured that Clime's capital has been maintained despite the payment of regular quarterly dividends. This has been achieved through high cash weightings and exposure to stable high yielding securities.

| Investments | 31 Jan '12 | 29 Feb '12 | 31 Mar '12 | 30 Apr '12 | 31 May '12 | 30 Jun '12 |
|---|---|---|---|---|---|---|
| Listed Securities | $53.5m | $52.8m | $53.8m | $54.0m | $53.6m | $54.0m |
| Cash | $10.0m | $11.4m | $11.5m | $11.3m | $9.9m | $9.9m |
| Net Assets | $63.4m | $63.9m | $65.3m | $65.3m | $63.5m | $63.9m |

## $10,000 invested in Clime Capital vs LIC and Accumulation Indices




Data Sources: Thomson Reuters; IRESS

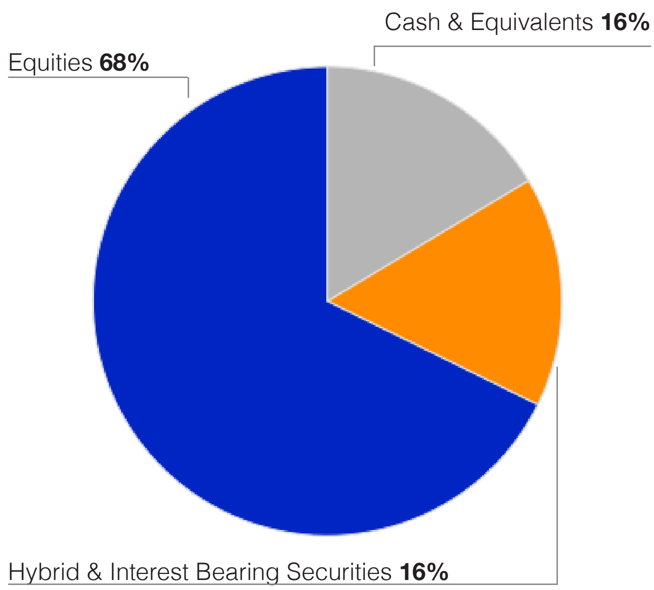
# Portfolio - 30 June 2012

Portfolio turnover remained low over the quarter with little need to make major portfolio changes.

Ahead of the RBA's decision to reduce the cash rate our attraction to floating rate securities had been tempered. Consequently, the holding in Australand notes has declined over the quarter.

The holding in Ethane Pipeline has been trimmed as the price appreciated. Mineral Resources was trimmed at elevated prices early in the quarter; with the benefit of hindsight we may have been more aggressive. Despite the price fall we perceive that this business displays a strong fundamental quality and has an outlook for earnings growth (despite weaker commodity prices) that is not matched by many other listed entities.

The price of BHP has fallen over the quarter as consensus earnings are lowered for future years. Whilst the forward valuation of BHP has thus declined it is still some 35%+ above current price levels which is a satisfactory margin of safety. We remain comfortable



holders and would consider additions on price weakness. We marginally increased our holding over the quarter.

The holding in Brickworks Limited has increased as the price fell through the quarter. The investment case remains attractive with the price trading well below NTA which is conservatively stated. Whilst building activity remains depressed, Brickworks is positioned strongly for a rebound in activity. Recent interest rate reductions, government policy actions provide encouragement with a medium term view.

The holding in Coca Cola Amatil was sold when its price appreciated swiftly beyond value. We remain attracted to the business however the price is currently near our valuation for December 2013 and the risk of a price correction is elevated. We understand the business well and will watch from the sidelines while it trades at expensive price levels.

Similarly, the holding in M2 Telecommunications was sold after following the recent acquisition by the company. Profitability is likely to be permanently impaired and financial quality is set to fall as debt & goodwill levels rise. The dilution caused by the capital raising and additional risk caused our valuation to fall and the share price to look expensive relative to recalibrated expectations.

New portfolio positions in IRESS Limited, Forge Group, Blackmores Limited, Reece Limited and Thorn Group were created as the price of these quality business fell to attractive levels.

The holding in McMillan Shakespeare Limited was slightly reduced on the basis of portfolio risk management as the price appreciation increased its portfolio weight. Our conviction remains as management continue to display a strong ability to execute capably and the growth opportunities are among the best available today. We are continuously alert to our responsibility of managing the portfolio and have self imposed limits for position weights to maintain sound risk management.

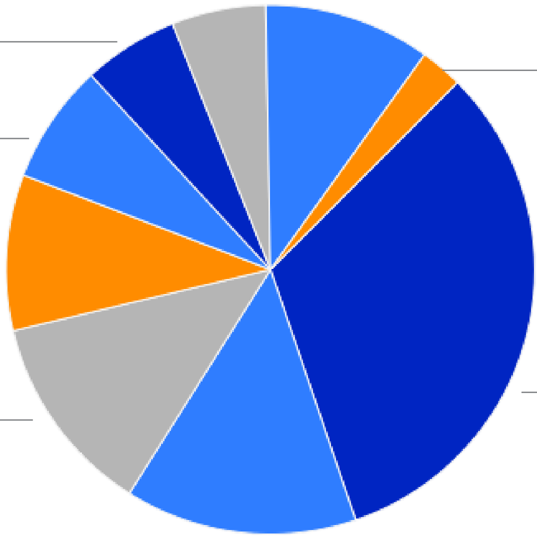
The holding in Oroton Group was lifted as the price fell. Whilst short term earnings growth expectations have reduced, the company displays strong financials and high profitability levels derived from controlling their brand. Controlling the brand cannot be underestimated. Savvy shoppers increasingly use their mobile phones to price check products (frequently within a traditional retailer), often finding satisfactory offerings online from overseas retailers. Where a consumer decides they want an Oroton product they have no choice but to buy it from Oroton. The key for Oroton is to continue to produce product that consumers desire, should they be successful here they can be sure not to be decimated via online channels as many retailers are today. Indeed the Oroton online ‘store’ is among the most productive stores in the group due to its convenience and the use of brand loyalty promotions.

The significant Telstra holding was reduced as the price moved swiftly above our 2012 valuation. However, the business continues to attract us to its yield in this low growth environment. Management finalised the NBN agreement early in the quarter. We expect the NBN rollout to be slower than expected providing Telstra with a windfall over time.

Small additions to holdings in Westpac and Woolworths were made when price volatility presented an attractive acquisition point. Moderate growth and good yields from both holdings will provide satisfactory real returns over time.

As at the 30th June Clime holds a meaningful cash reserve in anticipation of continued opportunity from market volatility. The lower cash rates reduced the relative attractiveness of holding cash and equivalents. Over the longer term cash is likely to be a poor investment and the intention is to become more invested as attractively priced opportunities present.

## Sector Allocation




# Market Outlook

Today we are witnessing falling interest rates through decisions of the RBA and so we ask - Will the economy respond? In normal cycles lower rates stimulate both business and consumers into more economic activity. Maintaining future price expectations and GDP growth are the key focus of the RBA's decision making process. But clearly overseas events are impacting this process. Today we see bond rates in the UK around 300 year lows, US rates at 60+ year lows & Japanese rates approaching zero. The significance of these observations requires careful consideration because it is currently not clear that lower rates will now stimulate consumption and therefore economies.

However, based on the current interest rate environment equities are broadly cheap and have been so for some time. The catalyst for a general rise in equity prices is difficult to anticipate and so the value based approach that Clime adopts, away from indexing, has and should continue to perform much better than the market. Whilst at some point positive sentiment will return it is only those companies that can consistently grow earnings through the cycle that attract our capital. Clime does not allocate capital on hope but based on observed growth and a rational view of value.

Therefore, we are not forecasting a substantial lift in equity prices but our valuation analysis suggests that the equity market should generate a positive return in the next 12 months but stock selection and yield remains a critical requirement.

The equity market rewards consistent earnings growth with consistent price appreciation. The period post GFC has been difficult for market wide share price or value growth; this has resulted from stagnate and/or declining earnings. During this five year period without earnings growth, businesses have retained earnings (~30% per year) and deleveraged. This has been a challenging period for equity investors. It is this lack of earnings growth coupled with growing retained earnings, not currently deployed productively, that has in part influenced our preference and focus for yielding investments, while keeping our search for growth &

quality. The yield being harvested via hybrid and equity assets by your manager enables the reinvestment decision to be rationally assessed and dividends to be paid to Clime shareholders.

It is clear that most developed bond markets are extremely expensive and therefore current buyers are accepting very low returns in exchange for the probability that they will get their capital returned, albeit in nominal dollars. Real returns from major bond markets are likely to be negative for investors of today unless deflation occurs. In the era of fiat money deflation to us appears a low probability.

The equity market in contrast is attractive on metrics such as price to book, price to earnings and dividend yield relative to its twenty year averages. Sentiment is poor and risk aversion is high creating attractive pricing. Therefore, Clime has increased the pace of investment recently aided by the elevated volatility and negative sentiment emanating from the economic headwinds from Europe.

These headwinds are the result of poor political leadership and resolve. It results in the current monetary union struggling to deal with issues that only a fiscal union is likely to tackle effectively. The challenge is forming a view on the likely outcome when significant political uncertainty exists however it is arguable that much of this uncertainty is priced into markets at present. Holding cash provides comfort in uncertain times but it will be a wasted asset if it is not employed when value appears for quality listed investments. Thus, over the coming 12 months it is likely that Clime will become near fully invested and particularly so if sentiment declines further.

More important for Australia's growth is that China has started to stimulate their economy following a necessary policy tightening to curb inflation last year. Broad economic indicators in the US remain patchy with a number of indicators suggesting weaker economic growth than normal at this point in the recovery. This has encouraged the US Federal Reserve to extent recent stimulus efforts. The large unconventional gas reserves and rapid pace of technological development do present opportunity for the US to reclaim a competitive edge that may have dimmed in the last decade subject to policies and regulations not becoming more challenging.

It is important to remember that the best time to accept more risk in pursuit of returns is when most participants are fleeing from it. It is then that risk is mispriced to a buyer's advantage in contrast to a period when buyers are competing to a seller's advantage. Thus, the current environment does encourage the Manager to be cautiously optimistic for satisfactory returns from equities in the year ahead. The Manager and therefore Clime with a stable capital base has strong staying power and a strong stomach to stay the course. This has yielded sound results in recent years. Shareholders can rest assured that their capital is in safe hands.

In conclusion we thank you for your continued support of Clime Capital and the entrustment of your investment capital with us. Should you wish to discuss any of the above please do not hesitate to contact us.

**Kind Regards,**
John Abernethy, *Chairman*
George Whitehouse, *Portfolio Manager*

# Demystifying Intrinsic Value

Many market participants think that the way to make money in the stock market is to buy shares at one price and to sell them at a higher price over the following days. In the short term prices are unpredictable and are often influenced by the irrational activity of market participants - many of whom are either undisciplined investors or consistently irrational.

Investing is different because it is based on the concept that when you buy shares you are buying part ownership of a business. Investing works because it is founded on the notion that **Price** and **Value** are different concepts.

Every business has an intrinsic value derived from its return on equity (profitability) and its inherent business or investment risk. This value may show no resemblance to the current market price because the market is not always efficient or rational. It is a business's fundamentals and its performance, both historical and forecast that creates the value.

*In contrast it is the price that creates the opportunity.*

Fortunately valuing a company is no more difficult than 10th grade algebra and below we have presented a worked example with Blackmore's Limited (ASX:BKL). Success over time requires a level head and the ability to think and act like an owner.

*Price is what we pay and value is what we get.*

Whether it is for a share in a company or for the groceries that we purchase at our local Woolworths - value is what we receive. However, whether we have received good value or not is easily observable at Woolworths. We can observe the price for the same goods at Coles!

In the stock market, however, it is far more difficult comparing, say, the price of BHP to the price of RIO to determine value: the companies may both be large, diversified mining groups, but their differences are vast. Deciding whether BHP is being offered at an attractive discount can best be determined by comparing the price of BHP to the assessed value of BHP.

As an example - suppose you are following a listed company and its shares fall from $30 to $25. Should we buy shares? What if the price falls further to $20 or even $15? When is the time right to buy?

We are only active buying a company's shares when we have conviction that intrinsic value is meaningfully above the price on offer and the business meets our qualitative criteria. We do this intuitively for groceries because of access to advertised pricing of the same goods. However, it requires a focus and discipline with shares where the market price oscillates minute to minute and day by day.

Having a view on intrinsic value gives us a strong competitive edge against other market participants.

For decades people have refined and revisited the process to estimate the intrinsic value of a business. The intellectual framework was set by **Benjamin Graham** in the 1930's. This was further developed in the 1960s by **James Walter** with **Phillip Fisher** adding meaningfully to the qualitative process/framework.

**Warren Buffett** leveraged off Graham's works and teachings to develop the method to value businesses that distributes all of their profits. The final piece of the puzzle was refined by **Richard Simmons**, an Oxford MBA, who developed the method to value the growth component of a business.

Thus the concept of intrinsic value has been developed over decades with the intellectual rigor of some of the world's most successful investors.

Intrinsic value is not static, it is likely to change at least twice a year as a company reports its half and full year results. Indeed, intrinsic value may change more frequently due to corporate events such as changes to company guidance, acquisitions, buybacks and capital raisings however value changes much less frequently than price.

### *Required Return is an assessment of risk.*

An important input in the derivation of intrinsic value is the rate of return that a rational investor requires to hold shares in a business. A share is a higher risk asset as it cannot be redeemed. To compensate an investor for the higher risk, the returns from a share investment must be substantially higher than a lower risk asset such as a government bond or bank deposit.

Risk is not measured by price volatility. Price volatility creates the opportunity for an investor. Risk is best thought of by asking a question: When investing this capital, will I preserve my purchasing power and achieve a sound additional return? The real risk when investing comes from misjudging intrinsic value, business quality, inflation and tax rates.

### *Required Return is comprised of:*

1. The **Risk Free Rate**: An investor taking their capital out of the safety of a bond to buy part of a business must demand a higher return than the "risk free" rate (defined as the 10 year government bond yield);
2. The **Equity Risk Premium**: This is the difference between the long bond yield and the equity market total return, and is observable over time. Equity investments have averaged between 5 and 6% above the long term bond yield in Australia over the past century.
3. Finally, a further risk margin is added based on **company specific risk factors**. Investing in any particular business entails a large range of variables affecting the sustainability of the business performance.

We 'normalise' the earnings of a company so as to create the economic picture an owner would see.

In Australia, owner earnings must include the franking credits attached to dividends paid and this is termed 'grossed up' dividends. Franking credits are of immense value to investors and essential to be considered in a valuation. All Australian investors benefit from receiving franking credits at tax time.

### Normalised Earnings consists of:

Grossed Up Dividends
\+ Retained Earnings
\+ Change in Reserves
\- Abnormals

Once we have the correct picture of earnings we can calculate a key component of intrinsic value; Return on Equity. Often investors put too much focus on what comes out of a company in the way of profits and dividends rather than focusing on the equity that has gone into and retained by a company to produce the profits. The key is to consider both via the Return on Equity measure of profitability.

### ROE consists of:

$$\frac{\text{Normalised Earnings}}{[\text{Opening Equity} + (\text{new net ordinary equity}/2)]}$$

Once we have our ROE we estimate a sustainable 'Payout Ratio'. Once we have our ROE and the Payout Ratio, we make an assessment of the sustainability of both by considering the industry and the company position. We now have the four key variables to the valuation process:

ROE
The profitability of the business.

Dividends (D)
The amount of profitability paid to owners as dividends.

Reinvested (RI)
Reinvested in the business to grow the business.
(ROE – D).

Required Return (RR)
The return we need to become owners of the business.

Businesses have both bond and growth characteristics. As such the intrinsic value of a company considers the **bond** characteristics and the **growth** characteristics of the business. Recognising this, the valuation approach has two components that are separated by the sustainable payout ratio. The Payout Ratio is important as it rewards the intrinsic value of businesses that have high ROE and can retain and compound capital at attractive rates. Conversely it punishes businesses that have low ROE and decide to retain capital at subpar rates of return.

**1. The Bond Multiple**

$$\text{Equity Multiple} = \frac{\text{NROE}}{\text{RR}}$$

**2. The Growth Multiple**

$$\text{Equity Multiple} = \frac{\text{NROE\^{}2}}{\text{RR\^{}2}}$$

**3. Payout Ratio**

= [Bond component multiple] X [the payout ratio]

= [Growth component multiple] X [1 - the payout ratio]

**The total Equity Multiple is the addition of the two.**

Once the Equity Multiple has been calculated the final step is to multiply the Equity for each share on issue by the Equity Multiple.

*Finally and possibly most importantly - the buy, hold and sell decision.*

# Blackmores Limited

## A healthy example

**Normalised Earnings**

= 27.3 + 8.2 + (-0.9) – 0

= $34.6M

*Blackmores generated $34.6M of Normalised Earnings to owners of the business in 2011.*

**Normalised Return on Equity**

= 34.6 / (71.8 + ( 0 / 2))

= 34.6 / 71.8

= 48.2%

In 2011 Blackmores provided a very healthy return to owners of 48.2% on the money owners have put into the business and left in the business via retained earnings. Clearly this is a wonderful return that has been consistent for a decade; a demonstrated track record.

Once we have our NROE, we can determine the 'Payout Ratio' by dividing our 'Grossed up Dividends' into our 'Normalised Earnings', in this case we get 78.9% (27.3/34.6).

When we have calculated our NROE (48.2%) and Payout Ratio (78.9%), we make an assessment of the sustainability of both by considering the industry and Blackmore's particular circumstances. We now have the four key variables for the valuation process.

**NROE: 49%**
**Dividends (D): 39.2%**
**Reinvested (RI): 9.8%**
**Required Return (RR): 13.5%**

**The Bond Multiple**

= 0.49 / 0.135

= 3.630

**The Growth multiple**

= (( 0.49^2) / (0.135^2))

= (0.24) / (0.018225)

= 13.169

**Adopted Payout Ratio**

80%

**Bond component multiple**

3.630 x by the payout ratio (80%): 2.904

**Growth component multiple**

13.169 x (1 – 80%) = 2.634

**Total Equity Multiple**

(2.904 + 2.634) = 5.538

*Once the Equity Multiple has been calculated the final step is to multiply the Equity for each share on issue by the multiple. Blackmore's had $4.72 of equity per share at June 2011.*

## Intrinsic Value = $26.14

($4.72 x 5.538)

# About Clime Capital Limited

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Clime Capital Limited (ASX:CAM) was listed on the ASX in February 2004 to provide investors with the opportunity to participate in a long-term approach to portfolio investing using value investing principles.

The company's investment objective is to generate returns for shareholders by investing in businesses with understandable economics and excellent growth and income potential that are run by capable management.

The company was formed to provide access for all investors to a strategy intended to create long-term wealth by purchasing, at rational prices, a portfolio of businesses whose earnings are expected to increase over the years.

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# Notes

# CLIME CAPITAL LIMITED

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