Clime Capital Limited (ASX:CAM)

# Quarterly Report

June 2013

www.climecapital.com.au

Dear Fellow Shareholder,

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

On a sober reflection the 10% correction in the share market during the recent June quarter was justified. Earnings downgrades were certainly a feature of the market in the June quarter. Indeed the earnings guidance of many companies simply reflected the deteriorating economic and business climate in Australia. Most significant in our view is that the current returns on equity generated by leading Australian companies actually correspond to the poor returns achieved in the recession of 1992/93.

Unfortunately from this point it looks like business conditions will deteriorate further before they bottom at some point in 2014. However, it is unlikely that Australia will recover quickly despite the tailwinds of a growing population and a lower currency. The reason is that Australia, like many other advanced economies, has allowed its economy to move too far towards services and away from manufacturing or to "adding value" to resource exports. China has decisively taken the pre-eminent position of world manufacturing and so much of the developed world has lost the leverage from a weakening currency.

The clearest example or precedent of what could be the outlook for Australia is the United Kingdom. There we see an economy that suffered greatly from the financial effects of the GFC but which has failed to recover despite a significant devaluation, rolling fiscal deficits, low interest rate settings and massive quantitative easing. What is clear to see is that an unbalanced economy is difficult to rectify even with enormous stimulation. A heavy reliance on financial services does create a massive burden for government and it is an industry that receives no benefit from a weak currency. Indeed this is magnified if a weak currency has no productive sector to stimulate.

Australia is different from the UK due to our significant resources sector but this sector is not a big employer and nor does it offer much added value to what it digs up. However, our burgeoning reliance on the services part of our economy mean that economic benefits of the weakening $A are not widespread. Some 10 or 20 years ago a devaluation would have been very positive for the Australian share market, but today its affects look to be very concentrated to companies with offshore operations or our major resource companies.

Thus, the high levels of cash retained in our portfolio are justified given the difficult outlook for the broader economy and our observation that share prices appear to be full when compared to intrinsic value. Ultimately it is growing profits and improved profitability that will lift valuations. However, at this point there are far more companies that are struggling then are benefitting from the weakening $A.

Kind Regards,

**John Abernethy**, Chairman

## In this issue


| | |
|---|---|
| Chairman's Letter | 1 |
| Offer to Shareholders | 2 |
| Investment Objectives and our Process | 3 |
| Performance | 4 |
| Portfolio Summary | 5 |
| Outlook and Market Commentary | 8 |

# Offer to shareholders

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

The Clime Listed 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;
- Clime pays quarterly dividends to ordinary & preference shareholders; and
- High levels of transparency by being listed on the ASX.

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 excessive or value is not apparent. The Manager has the ability to look across listed asset classes to seek absolute 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.

| Ordinary Shares Overview (ASX:CAM) | |
|---|---|
| Share Price (as at 30 June 2013) | $1.04 |
| Rolling 12 Month Dividend | $0.04 |
| Historical Dividend Yield | 3.8% |
| Percentage Franked | 100% |
| Grossed Up Yield | 5.5% |
| Dividend Reinvestment Plan | Yes |

| Preference Shares Overview (ASX:CAMPA) | |
|---|---|
| Share Price (as at 30 June 2013) | $1.93 |
| Rolling 12 Month Dividend | $0.19 |
| Historical Dividend Yield | 9.8% |
| Percentage Franked | 100% |
| Grossed Up Yield | 14.1% |
| Dividend Reinvestment Plan | No |

*Converting Preference shareholders will accrue the bonus issue and upon conversion will receive 1.30967 Ordinary Shares for every Converting Preference Share.*

# 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 **&** **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 judgement and 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

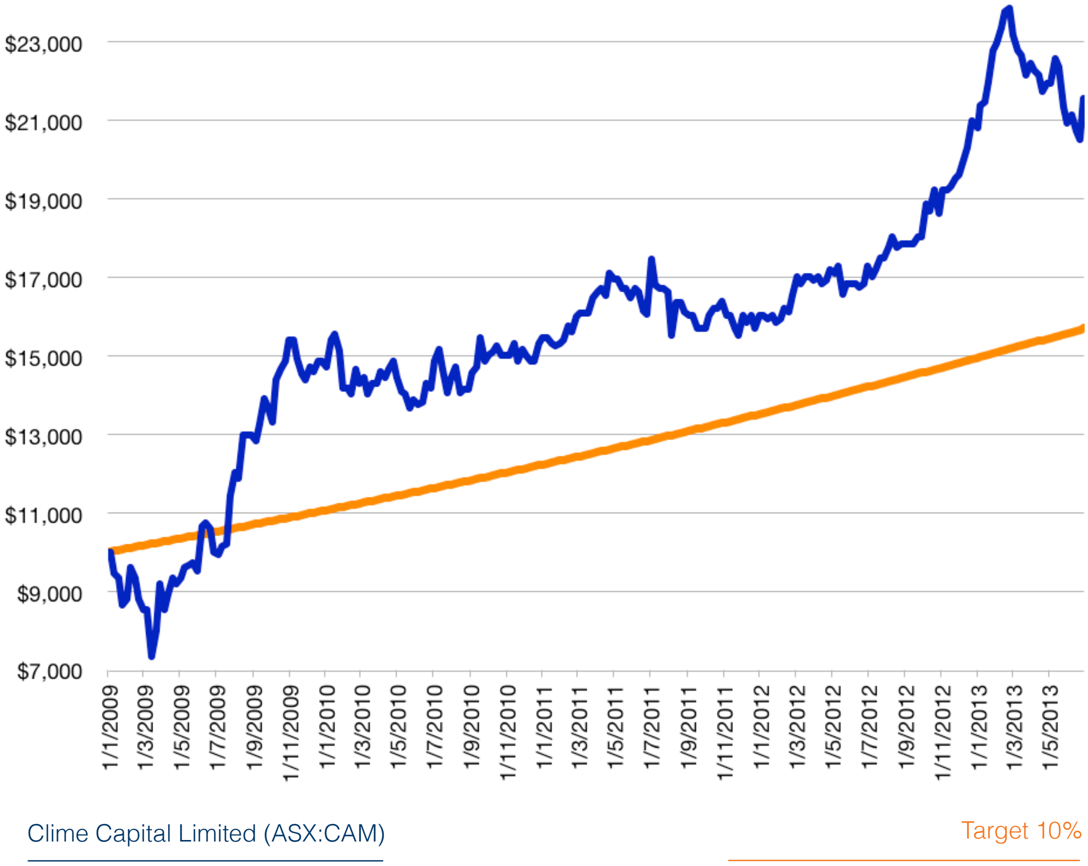
*The returns of Clime, under current management, have generated strong outperformance over time.*

| As at 30 June 2013 | 1 Year | 3 Years | 5 Years |
|---|---|---|---|
| Clime Capital Total Shareholder Returns | 24.6% | 13.2% p.a. | 14.1% p.a. |
| | | 44.9%. | 93.6% |

Clime's returns do not include the added benefit of franking credits which are attached to dividend distributions. Further, the returns reported for Clime are after all management and transaction costs.

More recently and despite market volatility, the Manager has ensured that Clime's capital has been maintained along with the payment of regular quarterly dividends to both ordinary and preference shareholders.

## Year Shareholder Returns: $10,000 (Jan 2009 to Jun 2013)




Data Source: Thomson Reuters

# Portfolio - 30 June 2013

## Investments

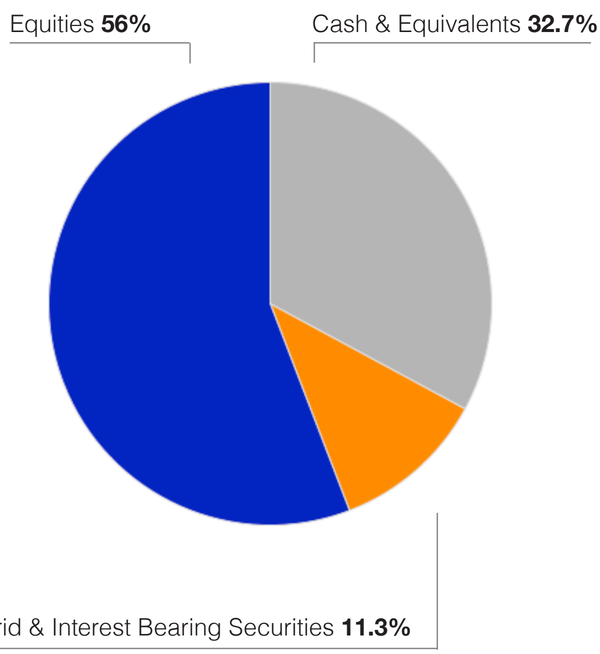
| Investments | Jan'13 | Feb '13 | Mar '13 | Apr '13 | May '13 | Jun '13 |
|---|---|---|---|---|---|---|
| Listed Securities | $61.5m | $60.3m | $61.0m | $66.9m | $58.4m | $57.4m |
| Cash | $9.6m | $16.7m | $15.0m | $23.7m | $28.9m | $27.9m |
| Net Assets | $71.0m | $77.0m | $76.0m | $90.6m | $87.3m | $85.3m |

During the period bank equity was reduced from 21% of the portfolio to 12% as a result of the placement & rights issue and a decision to marginally reduce bank holdings primarily reflecting valuation considerations. We are cognisant of the characteristics of bank equity which is not akin to low volatility utility type dividend payments however more reflective of leveraged cyclical characteristics that the market from time to time forgets to focus upon. Our broad local economic thesis indicates the local economy is slowing, whilst not extreme at this point history indicates that as GDP growth slips below 2.5%, unemployment often moves meaningfully higher. Unemployment is a significant risk factor for banks, in recessionary times bad debts & provisioning place significant pressure on profits & dividends. While a significant increase in unemployment is not our base case today we are watching the leading indicators for employment closely.

The investment in Telstra was reduced during the period as attractive pricing presented. Our attraction to Telstra from a yield perspective remains and reflects our view that in a time of constrained economic and earnings growth, yield forms a significant part of total returns.

The long held Reject Shop position was reduced during the period as pricing reflected an overly optimistic view of the likely forward looking profitability. The business sensibly raised additional capital above fair value to take advantage of additional store opportunities left by a weak competitor. This resulted in recent strong share price appreciation. Share prices significantly above assessed valuations reflect an opportunity to capture tomorrow's investment returns today and serve to increase risk of subpar future returns. We continue to execute our process and reduce holdings of expensive equity.

## Asset Allocation




The holding in BHP Billiton was marginally increased during the quarter as attractive pricing presented, a new holding in Rio Tinto was established late in the period as attractive pricing presented. The investment in Mineral Resources was maintained while moderate new holdings in Ausdrill Limited, Imdex Limited & NRW

Holdings Limited were added during the period as significant discounts to assessed valuations presented following deep primary research on the individual businesses. The area of the market today that is unpopular is certainly the resource and associated services sector. This current unpopular view is not without some merit and market pricing for construction based mining services do not appeal in the light of a likely meaningful fall in construction activity levels. There are numerous businesses that are focused on serving the expanded production activity in the resources sector that have been sold down remarkably in recent months. It is this area that is offering opportunity for investors who can think outside of consensus and conduct deep primary research.

The investment in SMS Management & Technology was increased over the period. We hold an out of consensus view on the medium term profitability of this business and look to improving business sentiment and investment post-election & deployment of cash reserves via acquisitions of businesses that add new capability to the service offering which is likely to result in reasonable cross sell opportunity.

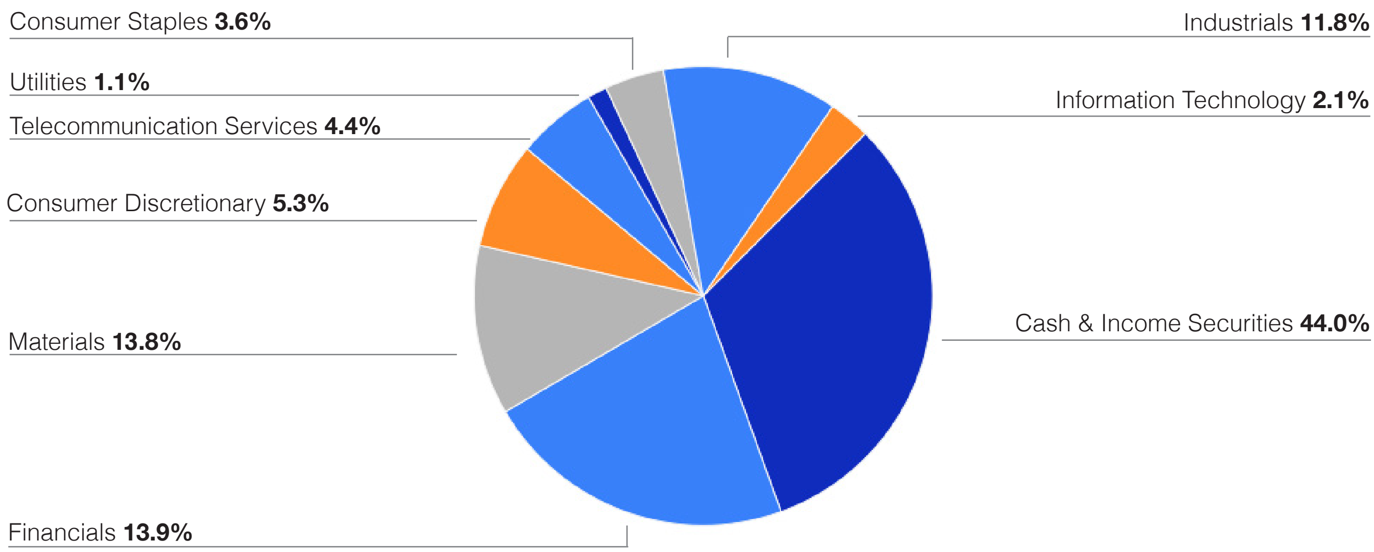
Holdings in Brickworks Limited, Reece Australia, Thorn Group, Treasury Group and Woolworths were maintained and all have displayed sound performances stemming from diverse and sound underlying business fundamentals.

Early in the new period we began acquiring a position in a leading high quality building material business at a sound discount to our assessed intrinsic valuation with attractive medium term opportunities. We will outline our investment thesis in the next quarterly report.

As at the 30th June Clime holds a meaningful cash reserve, in anticipation of continued opportunity.

| Top 15 Holdings as at 30 June 2013 | Weightings |
|---|---|
| BHP Billiton Limited | 8.37% |
| McMillan Shakespeare Limited | 4.88% |
| ANZ Banking Group Limited | 4.79% |
| Westpac Banking Corporation | 4.47% |
| Telstra Corporation Limited | 4.42% |
| Multiplex Convertible Note | 4.33% |
| Brickworks Limited | 4.19% |
| Woolworths Limited | 3.62% |
| Commonwealth Bank of Australia | 3.24% |
| Mineral Resources Limited | 2.62% |
| The Reject Shop Limited | 2.38% |
| SMS Management & Technology Limited | 2.05% |
| Seven Group Holding Convertible Note | 2.02% |
| Thorn Group Limited | 1.96% |
| Australand Convertible Note | 1.92% |
| **Cash & Equivalents** | **32.73%** |
| **Total** | **87.99%** |

## Sector Allocation




# Outlook and Market Commentary

During FY13 the All Ordinaries price return was 15%. While on the surface quite a sound return, this was delivered in the face of the second year of broad corporate earnings contraction, the return was a result of price expansion alone. We remain cautious of extrapolating recent price performance in the face of a softening economic outlook and moderate corporate earnings growth in Australia.

The market is inherently short term orientated and significantly influenced by the sell side who engage in 'marketing' rather than encouraging clients to invest over the cycle for medium to long term returns. This activity has spawned a whole series of short term speculators only interested in instant gratification. Fortunately this short term focus creates opportunity for investors, such as your manager, to look through next month's NPAT number and focus on the industry position & productive capacity of equity via the cash flow statement and balance sheet toward a medium to longer term view. The market may overshoot or undershoot in the near term as a result of the popular opinion and 'marketing' of the day however in the medium to longer term a time arbitrage exists as it is the fundamentals that drive total returns, this is the primary focus of Clime's investing activity.

We do not live in a sterile world of linear investment outcomes and should not expect linear returns from listed asset classes. It is the sectors and companies that are operating with headwinds where attractive prices exist as the sell side, only looking to the next NPAT number, stop 'marketing' the equity of these sectors which skews the supply/demand balance leading to price falls. Commonly the popular press and talking heads amplify the myths when describing the sector headwinds of the day creating a second wave of selling to accompany the institutional 'underweight' views. All this activity focuses on the psychological fear & greed emotions and creates the market volatility that presents opportunity. Perversely it is volatility that is one of a rational investor's best edges in the market.

In years gone by finance/banks, retail & building materials have experienced business headwinds which have been exaggerated by the sell side & media, due to their short term incentives, and provided significant opportunity for investors willing to do primary research on the quantitative & qualitative aspects. Finance/banks, retail & building materials companies have been your company's highest returning investments over the previous few years, all purchased when ignored by the market herd. Today resources and service companies are facing headwinds and attractive prices are being presented.

The portfolio is constantly a combination of ideas at different stages of their investment lifecycle, some quite new and some rather mature. We continue to search listed asset classes for sound opportunity and remain content to stand aside from the market herd at times when forward looking fundamentals appear appealing & our primary research indicates opportunity.

The market has moderated somewhat over the past few months from a level we regarded as mildly expensive. Asset prices are quite responsive to monetary & fiscal policy settings and have broadly inflated over recent years around the globe as newly created money seeks returns. Markets today however are starting to contemplate what happens particularly in the US where fiscal settings are contractionary and monetary conditions are looking to be less loose albeit without the likelihood of near term tightening. Recently in the US, as well as locally, we have seen a steeper yield curve which has historically indicated improving growth prospects, broad global QE is likely still distorting this metric today. We certainly see signs of improvements in the US economy driven by improving employment outcomes however locally, economic indicators are much more mixed.

Of late we have not discovered many attractive opportunities and consider the Australian equity market as approximately fair value. We maintain a watch list of companies in case they fall out of favour and we get the chance to buy. Our cash levels are a little higher than we would like however we feel that this will give us solid flexibility to take advantage of future opportunity particularly with regard to current market prices and perceived risks.

Over the longer term, quality equities produce better returns than cash, the probabilities of positive returns increase with lower entry prices and longer views. In order to find attractive assets at low prices we must buy unpopular assets and be out of sync with consensus thinking from time to time.

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,**
George Whitehouse, *Portfolio Manager*

# 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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