PERENNIAL GROWTH MANAGEMENT

Perennial Socially Responsive Shares Trust

Monthly Report
28 February 2015

	Month	Quarter	FYTD	1 year	2 years	3 years	5 years
	%	%	%	%	% p.a.	% p.a.	% p.a.
Perennial Socially Responsive Shares Trust*	7.5	11.8	10.0	13.7	13.3	15.9	8.8
S&P/ASX 300 Accumulation Index	6.9	12.6	13.0	14.2	12.2	15.8	9.5
Value Added (Detracted)	**0.6**	**-0.8**	**-3.0**	**-0.5**	**1.1**	**0.1**	**-0.7**
Net Performance	7.4	11.5	9.3	12.6	12.2	14.9	7.7

* Gross Performance. Past performance is not a reliable indicator of future performance.

Perennial Socially Responsive Shares Trust

The Trust aims to provide a total return (after fees) that exceeds the S&P/ASX 300 Accumulation Index measured on a rolling three-year basis, by investing in a selection of listed companies which also embrace and engender social performance in their corporate culture.

Portfolio manager:
Lee Mickelburough

Risk profile:
High

Trust FUM (as at 28 February 2015):
AUD53.7 million

Income distribution frequency:
Half yearly

Team FUM (as at 28 February 2015):
AUD2.6 billion

Minimum initial investment:
$25,000

Trust inception date:
December 2001

APIR code:
IOF0117AU

- **The Trust outperformed the Index by 0.6% in February.**
- **The key contributors to Trust performance were Mayne Pharma Group, Woolworths Limited (not held) and Karoon Gas Australia.**
- **We are seeing companies trying to keep shareholders onside through cost outs and the cutting of capital expenditure programs to support dividends, where they should be re-investing for growth in order to defend their profits.**

Trust performance overview

The Perennial Socially Responsive Shares Trust (the Trust) outperformed the S&P/ASX300 Accumulation Index (the Index) by 0.6% in February, finishing up 7.5% against the Index which rose 6.9% for the month.

The market rallied strongly during February as lower interest rates in Australia boosted investor sentiment. In contrast to recent months, Materials (up 11.9%) and Energy (up 9.2%) led the way, while Utilities (up 7.8%), Consumer Discretionary (up 7.7%), and Banks (up 7.0%) contributed strongly. Both Consumer Stapes (up 1.0%) and Telecommunications (up 0.6%) lagged the rally.

Reporting Season

The Australian reporting season occurs twice a year, with the first commencing at the end of January and the second the end of July. As management report their results for the half year prior and deliver their guidance for the period ahead, we are provided with the opportunity to review and confirm our investment views on companies that we follow.

As we have just reached the end of the reporting season, this edition of the monthly commentary will explore the themes that we have identified throughout the season and focus on what we view as the most important results.

Reporting Season themes - sectoral level?

The most important theme that we identified throughout the reporting season and one that we will follow closely is that we are seeing companies trying to keep shareholders onside through cost outs and the cutting of capital expenditure programs to support dividends, where they should be re-investing for growth in order to defend their profits. For too long companies have been taking the easy option paring back the growth plans of their businesses and returning cash to shareholders whose main primary motivation is supplementing their dwindling income owing to low returns on fixed income investments. This is a classic example of low interest rates being counterproductive to the growth that they should be stimulating. While there are presently few examples which demonstrate the longer term effect of this, we are seeing some initial warning signs in reports such as **Woolworths (not held, down 3.4%)** which we will elaborate on later.

Healthcare sector results were quite variable within the sub-sectors, with the key delineation, in our opinion, the level of Government funding support. We saw that Aged Care operators reported results above expectations as solid government funding and strong demand for services creating margins better than forecast. A prime example in our portfolio was **Regis Healthcare (up 22.9%)**, a recent listing which reported results ahead of prospectus forecasts including an upgraded FY15 earnings guidance. We feel that this theme has longevity owing to the aging population and funding structure of retirement living.

Australian focussed Engineering and Construction companies reported difficult conditions in the Infrastructure segment due to declining major project work outside of New South Wales. State Government issues in Victoria (East West Link cancellation) and Queensland (change of Government and reduced privatisation receipts) plus a deteriorating budget position in Western Australia keep the outlook far from certain. When we take this reduced project activity as a baseline and then factor in increased foreign contractor tendering activity, the margin outlook for contractors such as **Leighton Holdings (not held, up 6.8%)** in this sector is challenging.

Resource company management updates were a focal point of reporting season results and provided some very interesting insights into the sector which certainly gave us good reason to challenge our investment thesis on Australian mining companies. While we have remained broadly negative on the large bulk mining companies due to our view on the current supply and demand structure, it was evident that the performance of the sector was not as bad as we had envisioned. Overall we found that cost reductions and free cash generation ability was generally better than forecast. At first glance, we were amazed at what management teams were capable of when cash flow and earnings are under pressure from a lack of top line growth. However when we looked deeper, it certainly appears that all that glitters may not be gold.

The cash flow surprises across the sector appeared to have largely come from either working capital releases or asset sales, both of which may prove to be one off in nature and unsustainable in the longer term. Further, as we have mentioned earlier, capital expenditure reductions such as those announced by **BHP (not held, up 15.0%)** may serve to improve short term valuation metrics and support investor sentiment, but we hold a view that they will be limiting for the long term growth of the company.

We continue to favour commodities where we believe that supply fundamentals remain challenged and there is a strong equity story, whereby we see significant cash flow growth and above average return generation.

In the media and telecommunications space we saw the theme of operational expenditure growing and holding back profit margins. In most cases the expenditure was on new products and increased marketing as firms competed to maintain their market share and prominence within their industry. In summary businesses in this sector are having to spend money to make money. We feel that largely the “easy returns” have come to a majority of the online focussed businesses and telecommunications companies and we are seeing a turn to slower rates of growth in conjunction with higher competitive pressures. As a result we are seeing companies such as **Carsales (not held, down 2.8%)** and **Telstra (not held, up 0.3%)** turning to overseas options for expansion and we expect this trend to continue as they try and maximise their returns in their lower growth world.

Reporting Season highlights - company level

Mayne Pharma (up 52.4%) announced two very important transactions and in the process highlighted that the market is beginning to look for, and reward, growth. The first announcement was the end to litigation by Pfizer to stop the company launching its generic version of Pfizer’s Tikosyn drug. Tikosyn is used for the treatment of irregular heartbeat. Annual sales of the drug in the US are approximately US$150m. As Mayne Pharma was the first to file an Abbreviated New Drug Application (ANDA) for this molecule, if it is approved by the FDA, Mayne Pharma should be entitled to a 6 month period of exclusivity whereby no other generic version of the drug could be launched in the US. The earnings implications for Mayne are very significant. We estimate this drug may contribute up to US$23m in the first full year to market. The second transaction that Mayne announced was the acquisition of the Doryx brand and related assets from Actavis for US$50.0m in conjunction with two other key existing generic products in separate transactions for a payment of up to US$15.7m. Activis had mismanaged the distribution of Doryx and we feel that bringing the distribution in house to Mayne should result in at least a recovery in prescription volumes to previous levels. After taking into account the acquisitions mentioned and associated capital raisings the deal is highly accretive to growth and returns.

In our December commentary we flagged our negative view on **Woolworths (not held, down 3.4%)** as we believed the company was not well equipped to deal with the rising level of competition in the markets in which it operates and was losing market share as competition escalates in a weaker retail environment. It turned out that we were extremely close to the mark. Woolworths delivered a poor 1H15 result, cut FY15 guidance, replaced the head of Supermarkets and announced a strategic review. Sales trends continued to deteriorate in Supermarkets with like for like sales up just 1.2% in Q2.

Margins will be now likely be re-based as management announced a $500m investment in price over the coming years. This is being done to improve price perception which despite management denial, is now a major issue for the company. We also believe costs have been unsustainably cut: Management conceded they cut labour too aggressively in-store, and that this impacted in-stock positions, service and sales. While the re-investment has begun it will take time to deliver any benefits which suggests further downside risk to sales in the near term, in our view. We have been concerned for a number of years that Woolworths has been aggressively expanding its store roll out at declining returns. This unsustainable strategy is now being laid bare by competitive forces in the market.

The **QBE Insurance (not held, up 22.4%)** result demonstrated that the market is increasingly becoming divergent in its opinions on some companies, and in the process provided one of the most volatile days trading of the season. Post their result announcement QBE plummeted 5% before rallying 14% intra-day to finish up 9%. In the case of QBE, the market appears to have looked past the current circumstances of the business and taken comfort in the more stable earnings outlook and potentially improving dividend profile with accompanying franking. In contrast, we feel that the company has paid away upside to achieve more stable outcomes at the insistence of the rating agencies and at this price our view is that the stock remains expensive with modest profile of growth and returns.

The **James Hardie (up 16.3%)** result demonstrated that the US is still an epicentre for growth. James Hardie reported increased US market share gains in an already strong market and unlike many of its peers, was able to maintain healthy margins. Raw material cost pressures in pulp and cement were more than offset by gas, electricity, freight and to a lesser extent pulp moving for their benefit. We continue to see upside in James Hardie and believe that this story has further to run.

Investment Themes and Stock Performance

Outside of reporting season, there were some other portfolio highlights worth mentioning.

This month we a opened a new position in **Fairfax Media Limited (up 8.9%)**. Fairfax Media Limited is a multi-platform media group with a range of activities including publishing of news, information and entertainment, advertising sales in newspaper, magazine and online formats, and radio broadcasting. Amongst its business mix, we are most strongly attracted to Domain, its online and print residential property advertising service. With strong underlying growth and two synergistic acquisitions namely MMP and Allhomes, it is our opinion that Domain's earnings will increase rapidly. We expect Domain to pass 50% of group EBITDA during FY18, a rapid rise from the 23% in 1H15. The growth in Domain and ongoing decline in print revenues, leads us to view Fairfax as an online business with legacy print assets. We expect the stock to re-rate as this transition occurs.

One of our recent additions, **Incitec Pivot (up 12.7%)**, performed very well and is an example of a company that will grow dividend strongly during the next 2-3 years. In the short term, Incitec Pivot's earnings outlook is positive due to improved fertiliser earnings (a dramatically improved manufacturing performance and higher DAP prices) and improving US Explosives earnings which benefit further on translation into Australian dollars. More importantly, the company will complete construction of a $US800m ammonia plant towards the end of this year and current economics (solid ammonia pricing and cheap US gas) are compelling. So 2016 free cash flow will expand dramatically as plant expenditure finished and earnings contribute. The company has clearly flagged that the increased cash flows will be returned to shareholders through increased dividends and probably capital management.

We exited **Brambles (up 4.7%)** as we saw rising costs, lower growth forecasts and declining valuation support as catalysts to remove the company from our portfolio.

At the close of the month the Trust held 42 stocks and had an effective cash balance of 3.6%.

Market Overview

The Australian market soared 6.9% on an accumulated basis in the month of February spurred by the rate cut received early in the month. North American markets were strong with the S&P 500 rising 5.6%, the Dow Jones rising 5.6%, the Nasdaq up 7.1%. The theme continued across Europe with the Euro Stoxx 50 up 7.4% and the FTSE 100 climbing 2.9%. In Asia results were varied with the Nikkei 225 up 6.4%, while the Shanghai Composite Index only managed a more subdued 3.1% and the Hang Seng Index only 1.3%.

US Economic data was once again solid while the FOMC Chair Janet Yellen delivered an upbeat assessment of the economy at her semi-annual monetary policy testimony.

On the last day of February the Peoples Bank of China (PBOC) announced it will cut benchmark interest rates by 25 basis points effective from the 1st of March, with the one-year benchmark deposit rate now at 2.50% and one-year benchmark lending rate at 5.35%.

Chinese economic data remained patchy. The recently released HSBC Manufacturing PMI ticked up to an expansionary reading of 50.1, ahead of the 49.7 prior. January M2 money supply growth once again eased to 10.8% year on year, well below the 12.1% expected. New loan creation came in at 1,470B Yuan for January ahead of the 1,350B Yuan expected. The Chinese housing market remained under pressure with 64 cities of the 70 city house price index recording month on month declines.

The RBA cut the benchmark rate by 25 basis points in February to 2.25%, the first interest rate move since March 2013. This move reflects the RBA's expectation of a period of sub-trend growth to be "a little longer" and the peak in the jobless rate to be "a little higher". NAB business confidence increased 1 point to 3 points, while the NAB business conditions fell 2 points to a reading of 2. The Westpac MI consumer confidence index rose 8% to 100.7 following a small rise in the month prior. The economy shed 12,200 jobs in January well behind the 5,000 decrease forecast, while the participation rate remained flat at 64.75%. The jobless rate rose to 6.4%. Retail sales increased 0.2% in December, just shy of the 0.3% rise expected. Building approvals declined 3.3% month on month in December, well ahead of the 5.0% decline expected.

The Australian dollar rose 0.6% against the US dollar over the month, a small deviation from the trend of a stronger US dollar which has prevailed in recent months as the currency markets continue to transition to a more normal US monetary policy. The Australian dollar fell 1.3% against the Euro with the previously announced European Central Bank (ECB) Quantitative Easing program starting in March 2015 and continuing until at least September 2016 at a pace of 60bn Euro per month.

Best/Worst Performers			
(Best) company	Month Return	**(Worst) company**	Month Return
Mayne Pharma Group	52.4%	Bluescope Steel	-4.2%
Woolworths Limited (not held)	-3.4%	Seek Limited	-3.1%
Karoon Gas Australia	23.6%	QBE Insurance Group (not held)	22.4%
James Hardie Industries	16.3%	Transpacific Industries	-12.5%
AMP Limited	16.1%	Orocobre	-14.3%

New/Increased positions	
Bluescope	New Position
Fairfax Media	New Position
Asciano	Increased
Incitec Pivot	Increased
Mayne Pharma	Increased

Exited/Decreased positions	
Telstra Corporation	Exited
Brambles Limited	Exited
Iluka Resources	Reduced
Henderson Group	Reduced
Transpacific Industries	Reduced

Top 10 Holdings		
Stock name	Trust weight %	Index weight %
National Aust. Bank	8.7	6.1
Commonwealth Bank	8.2	9.9
ANZ Banking Grp Ltd	8.1	6.5
Westpac Banking Corp	7.1	7.9
CSL Limited	5.2	2.9
AMP Limited	3.2	1.3
Asciano Limited	3.1	0.4
Mayne Pharma Ltd	3.1	0.0
Westfield Corp	2.9	1.2
James Hardie Indust	2.8	0.4

Asset Allocation		
Sector	Trust weight %	Index weight %
Energy	2.2	4.6
Materials	13.9	15.4
Industrials	10.6	7.2
Consumer Discretionary	3.7	4.3
Consumer Staples	0.3	6.9
Healthcare	10.9	5.9
Financials-x-Real Estate	41.8	39.2
Real Estate	7.8	7.8
Information Technology	0.3	0.9
Telecommunication Services	2.5	5.7
Utilities	2.3	2.0
Cash	3.6	-

Rounding accounts for small +/- from 100%.

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Signatory of:

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