PERENNIAL GROWTH MANAGEMENT

# Perennial Socially Responsive Shares Trust

**Monthly Report**
31 May 2015

| | Month | Quarter | FYTD | 1 year | 2 years | 3 years | 5 years |
|---|---|---|---|---|---|---|---|
| | % | % | % | % | % p.a. | % p.a. | % p.a. |
| Perennial Socially Responsive Shares Trust* | 1.0 | 0.2 | 10.2 | 10.1 | 14.2 | 17.9 | 9.3 |
| S&P/ASX 300 Accumulation Index | 0.4 | -1.3 | 11.5 | 9.9 | 13.0 | 17.0 | 10.1 |
| **Value Added (Detracted)** | **0.6** | **1.5** | **-1.3** | **0.2** | **1.2** | **0.9** | **-0.8** |
| Net Performance | 1.0 | -0.1 | 9.2 | 9.1 | 13.1 | 16.8 | 8.3 |

* 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 31 May 2015):
AUD54.0 million

Income distribution frequency:
Half yearly

Team FUM (as at 31 May 2015):
AUD2.6 billion

Minimum initial investment:
$25,000

Trust inception date:
December 2001

APIR code:
IOF0117AU

- **The Industrials sector (up 5.6%) was the best performer in the month of May.**
- **The economic recovery in the US continues as evidenced by generally supportive economic data.**
- **Domestically, consumer confidence and business conditions have continued to weaken and the AUD will likely continue to slide.**

## Trust performance overview

The Perennial Socially Responsive Shares Trust (the Trust) outperformed the S&P/ASX300 Accumulation Index (the Index) by 0.6% in May, finishing up 1.0% against the Index which finished up 0.4% for the month.

Continuing their recent strong run, the Industrials sector (up 5.6%) was the best performer in the month of May. REITs (up 2.9%) also performed well while Healthcare (up 2.4%) partially reversed April's sell off. Materials (up 2.2%), Utilities (up 1.9%) and Consumer Discretionary (up 1.7%) continued their recent strength with solid returns. After a very strong April, Energy only managed a small gain (up 0.2%) while Telco's (down 0.2%) and Financials (down 1.7%) continued last month's weakness. Consumer Staples (down 2.2%) was the worst performing sector.

## Investment Themes and Stock Performance

**Companies which possess strong fundamentals for growth will continue to outperform**.

We added one new position this month in Australian Finance Group Limited.

**Australian Finance Group Limited (AFG) (new position)** is a mortgage broker with more than 2,300 members originating mortgage and loan products for their customers. AFG processes around $4.5 billion of finance every month and manages more than $100 billion in mortgage finance. Diversifying beyond mortgage aggregation, AFG also offers commercial finance, insurance products and AFG-branded and securitised products. The growth in the business is underpinned by the growth in Australian mortgages with AFG's continued penetration of the market we expect to see their cash flow growth exceed the broader system. We rate the management team including founders Brett McKeon, Malcolm Watkins and Kevin Matthews highly, having successfully built the business to be one of the largest mortgage broker organisations in the market place. While initially proving to be a challenger to major bank plans to support their bank infrastructure, this mode of distribution has now become critical to success for the lenders further adding to the investment case. We entered this investment with 42% upside to our valuation and see average growth of 12% over the next three years.

One of the most consistent performers this year, **JB Hi-Fi Limited (overweight, up 11.5%)** experienced another leg up after a $5.5 billion small business package was released as part of the Federal Budget. The package will see small businesses able to claim an immediate tax deduction for every item they purchase up to $20,000. Such items include many of JB Hi-Fi's product range including fridges, coffee machines, printers and computers. The 100% write-off is available to businesses with an ABN, earning less than $2 million in revenue. This stimulatory measure ties in neatly with JB Hi-Fi's developing "Commercial" and "Home" businesses, which are already driving growth and complementing their existing electronics stores network. The company is also currently benefiting from macro-economic factors including lower interest rates and lower petrol prices while a stronger housing market is leading to new homes being fitted out. While the news was another

incremental positive, we took the opportunity to trim our position and crystalize some of the gains we have made on this investment.

After flagging a re-introduction of dividends early in May, **Transfield Services (overweight, up 15.2%)** outperformed. Despite their Manus Island Immigration contract being up for tender, and their exposure to the energy sector, the company's shares traded higher as the company's increasingly diversified business mix and strengthening balance sheet is proving to be an attraction for investors and potential acquirers alike. While we continue to believe that Transfield has plenty of growth opportunities across government outsourcing in the defence, social and property sectors and feel they have the right management team in place for expansion, we used the recent sharp run up in their share price to lock in some of the recent outperformance.

Our position in **SAI Global Limited (overweight up 12.7%)** outperformed in May after the company announced it had entered a managed services agreement with HCL Australia Services to outsource a number of its IT related functions. SAI management expects the agreement to create approximately $27 million in savings over the five year deal. Approximately 20 HCL staff will be based in Australia with the remainder in India. SAI will be charged on a per employee basis and will be able to freely scale up or down the work force as required after the second year. This will provide significant operational flexibility to SAI Global.

**James Hardie (overweight, up 20.9%)** outperformed after reporting a much stronger than expected fourth quarter result and announcing a special dividend of US dollar (USD) 22.0 cents per share. In what is usually a seasonally weak quarter due to the North American winter, profit growth accelerated 26% and US fibre cement margins increased to 24.5% (versus 19.8% in the previous period). Margins were assisted by excellent plant manufacturing performance and also favourable movement in costs, notably freight, pulp, gas and electricity. Importantly these costs have continued to trend down since the full year result on 31 March, which sets the company up for further strong margin performance in FY16. Despite the share price move, we continue to see valuation support and believe the stock is the most attractive Australian-listed exposure to the recovering US housing sector.

**Mayne Pharma Group (overweight, up 4.6%)** continued its strong recent performance. In February Mayne acquired the Doryx brand in the US from Actavis. We monitor prescription volumes for this drug and they have been performing well during the transition phase to Mayne Pharma management. The solid performance gives us comfort that transaction is on track. The company has a large pipeline of drugs awaiting approval from the FDA in the US and if any of these are approved in the new financial year they will drive further growth. Following the capital raising in February and subsequent performance of the stock is now of the size that warrants inclusion in the S&P/ASX 200 Accumulation Index. This potential inclusion in the larger index is broadening investor interest in the stock.

**Metro Performance Glass (overweight, down 9.2%)** reported its maiden full-year result following its IPO in June 2014, slightly beating prospectus forecasts at the EBIT and NPAT level. Revenue growth was respectable at 11.1%, yet fell 2% short of the prospectus forecasts mainly due to industry-wide capacity constraints resulting in building approvals converting more slowly than normal into construction activity. This factor is expected to lead to a more elongated housing construction cycle in New Zealand which will ultimately be beneficial to the company. Crucially, Metro delivered on the commissioning of its Auckland manufacturing plant which consolidates North Island manufacturing from four sites to one in the North Island. This plant has a high level of automation and is already delivering materially reduced costs which, along with the cyclical upswing, underpin our forecast of profit growth in FY16. We believe Metro has an excellent industry position and capable CEO (Nigel Rigby, ex James Hardie) who is likely to see the company continue to achieve solid growth and superior return on capital.

We continued to add to our position in **Caltex Limited (overweight, down 4.9%).** As mentioned in previous commentaries Chevron's exit from the register is significant as going forward the majority of shareholders will be Australian and in favour of liberating the $1.1 billion of excess franking credits that sit on Caltex's balance sheet. Following the closure of the Kurnell refinery late last year (which has reduced earnings volatility and freed up substantial working capital), Caltex is arguably under geared and well-placed to either materially increase dividends or undertake off market share buybacks to distribute the franking credits. Caltex has an improving growth outlook, boosted by a company-wide cost out program which will deliver up to 10% earnings upside by FY16 and fuel retailing is assisted by the ACCC's decision to limit supermarket fuel discounts at 4 cents per litre.

**Challenger Limited (overweight, down 2.7%)** underperformed with no new news in the market.

We have reduced our position in **Regis Healthcare (overweight, up 1.6%)** after a period of strong outperformance. While we remain attracted to the company's growth prospects as the industry consolidates, the current elevated share price leaves no room for earnings disappointment from Regis or its industry peers. Recent industry research has pointed to a preference for lump sum accommodation payments (RADs) rather than daily payments (DAPs) under the newly introduced funding model. While delivering a similar economic outcome, the implication of the higher than expected proportion of RADs is positive for cash flow but negative for accounting profit. This could leave analyst earnings estimates for the sector vulnerable to disappointment at the upcoming results season.

We sold out of our position in **Isentia Group Limited (exited)** after a period of strong performance. Isentia used a trading update at the start of the month to re-affirm its prospectus forecasts for FY15 EBITDA of $41.3 million and NPATA of $27.2 million. While these numbers were solid, we found it increasingly difficult to justify the high valuation the market was placing on the business and felt that the market was not rationally valuing the downside risks of slower than expected market share gain across Asia and lower value added services penetration in Australia and New Zealand.

We also sold out our position in **Carsales.Com Limited (exited)** after a period of solid performance as it reached our valuation.

**The economic recovery in the US continues as evidenced by generally supportive economic data.**

This remains a central theme in our portfolio construction. We are seeing the gradual normalisation of US monetary policy, ongoing recovery in the US dollar and general upward pressure on US interest rates. We have chosen to play this central theme through tilting the portfolio towards those companies that have operations whose fundamentals will be supported in this environment.

We took advantage of short term share price weakness to add to our position in **Incitec Pivot (overweight, up 1.2%)** during the month. In the days immediately following Incitec's interim result, the Australian dollar (AUD) appreciated to above 80c and the stock price weakened. We viewed the result as solid, with excellent manufacturing performance at Southern Cross Fertiliser and good construction progress on the Louisiana ammonia plant which is now 75% complete. Incitec is one of the most leveraged stocks on the ASX to movements in the exchange rate via fertiliser sales and translation of US explosives earnings. We believe the stock has the potential for substantially increased dividends and capital management once earnings from Louisiana start to flow in late FY16.

**QBE Insurance (not held, up 6.9%)** outperformed in May. The sensitivity to the steepening US yield curve and its direct relationship to the present value of future claims liabilities continues to support the prospect of future earnings. While this is a positive for the company, we believe this is already reflected in the share price.

**Chinese economic data has remained underwhelming.**

The Chinese leadership face the reality of balancing long term reforms on corruption, the environment and market liberalisation with maintaining economic growth. Despite the weaker growth we had previously not observed any significant changes of government policy; consistent with our view that the leaders are maintaining a long term view of China's growth trajectory.

In confirming our earlier speculation that the Chinese government is becoming more aggressive in their management of the economy, the Peoples Bank of China (PBOC) announced its third interest rate cut in six months in May, reducing benchmark rates another 25 basis points, as well as lifting the ceiling of the deposit rate floating range from 1.3 times the benchmark rate to 1.5 times. We feel these moves may signify the government is becoming more concerned about the state of the Chinese economy, this could indicate that it is in worse shape than we previously had accounted for. In this light we feel that it is reasonable to maintain our cautious approach in relation to companies with direct exposure to China.

**Domestically, consumer confidence and business conditions have continued to weaken and the Australian Dollar will likely continue to slide.**

There will be a transitory period between the current weakness and subsequent recovery as the falling Australian dollar should assist in rebalancing the Australian economy in the longer term. As such, we have maintained a general underweight position to the Australian retail sector.

The Q3 2015 bank trading update was always going to be interesting given the noise in the market surrounding the future capital requirements as set by the banking regulator APRA. Following the updates, we moved to increase our position in Westpac Bank (overweight, down 5.4%). We like their shift in lending mix toward business lending at the expense of housing lending and the fact they remain relatively well capitalised, with their FY17E common equity tier 1 ratio (CET1) sitting comfortably above that of their peers. We increased the size of our underweight by selling **Commonwealth Bank (underweight, down 4.3%)** following its trading update as our investment thesis was confirmed with an earnings number that was not supported by the share price and we could envisage further headwinds in return on tangible equity. We participated in the **National Australia Bank (overweight, down 2.6%)** capital raising which facilitated their exit from their troublesome UK businesses and put the bank at the top of the capital ladder. After the company's shares traded very strongly after the raising, we trimmed our holding. We also added to our position in **Macquarie Group Limited (overweight, up 7.5%)** given our view of the superiority of their growth prospects in the current favourable market conditions.

We added to our position in **Veda (overweight, up 0.4%)** as we remain attracted to their strategy of extracting value from the comprehensive database they have created and diversifying the business into new areas namely fraud prevention, commercial and consumer scoring and supporting the marketing strategies of its customers. We forecast the company to generate strong cash flow and improving returns on capital and believe it is materially undervalued.

**Dulux (overweight, down 5.5%)** reported its interim result during the month which fell slightly short of expectations. The result showed solid revenue and EBIT growth of 6% and 9% respectively in the key Australia New Zealand Paints and Coating segment, where Dulux is benefiting from a strong housing market and its alignment with Bunnings in the retail segment. The shortfall occurred in B&D Garage Doors where both revenue and EBIT fell after Dulux implemented changes to the product range and dealer network. After meeting with management we are comfortable that the changes will be in the best interests of the business medium term and that revenue is already starting to recover. We expect Dulux to continue to achieve steady growth with superior return on capital and cash generation.

At the close of the month the Trust held 39 stocks and had an effective cash balance of 3.8%.

## Market Overview

The Australian market rose 0.4% on an accumulated basis in May underperforming most of its global peers. North American markets climbed with the S&P 500 rising 1.1%, the Dow Jones rising 1.0% and the NASDAQ rising strongly to finish up 2.6%. European markets were mixed with the Euro Stoxx 50 down 1.2% while the FTSE 100 increased 0.3%. Asian markets too were mixed with the Nikkei 225 the best performer soaring 5.3%. The Shanghai Composite finished up (a relatively subdued) 3.8%, while the Hang Seng Index fell 2.5%.

Despite first quarter real GDP growth being revised down to -0.7% from 0.2%, economic data in the US was generally stronger. Following a five month decline, the ISM manufacturing PMI found a base, matching the March reading of 51.5, just below the 52.0 expected. The ISM non-manufacturing PMI climbed to 57.8, well ahead of the 56.5 from the previous reading and the 56.2 expected. The Thomson Reuters/University of Michigan consumer confidence index stayed steady at 95.9 and was just behind the 96.0 reading expected. Non-farm payrolls climbed from 125,000 in March to register a reading of 223,000 in April, in line with the 225,000 expected. The participation rate rose 0.1% to 62.8% while the unemployment rate fell from 5.5% in March to 5.4% in April, in line with expectations. Housing starts soared 20.2% for the month of April, significantly ahead of the 9.6% rise expected and the disappointing 2% growth in March, so volatility in the series remains high. Building permits climbed 10.1% significantly ahead of the 2.1% appreciation expected. Core CPI for April rose 0.3% for the month just ahead of the 0.2% expected.

Chinese economic data remained patchy. The PBOC announced its third interest rate cut in six months, cutting benchmark rates another 25 basis points, as well as lifting the ceiling of the deposit rate floating range from 1.3 times the benchmark rate to 1.5 times. The HSBC Manufacturing PMI

was weaker than the market had forecast coming in at 48.9, weaker than the 49.4 expected and in line with the revised March number. April M2 money supply growth eased from March's 11.6% reading to 10.1% year on year, well below the 11.9% expected. New loan creation came in at 708 billion Yuan for April behind the 903 billion Yuan expected and behind March's 1180 billion Yuan number.

As was widely expected, the Reserve Bank of Australia (RBA) cut the benchmark rate by 0.25% to a record low of 2.0% in May. NAB business confidence stayed steady at 3 points in April against 3 points in March. The NAB business conditions fell 2 points to a reading of 4 points. The Westpac MI Consumer Confidence Index soared 6.2 points to 102.4 in May from 96.2 in April. The economy lost 2,900 jobs in April behind the 4,000 increase forecast, while the participation rate stayed steady at 64.8%. The unemployment rate rose to 6.2% an 0.1% increase on the prior reading. Retail sales increased 0.3% in March, behind the 0.4% rise expected and the 0.7% increase in the prior period. Building approvals increased 2.8% month on month in March, ahead of the 1.5% decline expected.

The most disappointing data release over the month was the March quarter capital expenditure survey. Apart from showing a sharper than expected 4.4% fall over the quarter, the second estimate for the total amount of capital expenditure for 2016/17 showed little improvement in non-mining investment intentions. With a large fall expected in mining capex, total capital expenditure is expected to fall significantly over the year ahead and highlights the need for other parts of the economy to offset the drag from growth that will come from business investment. The AUD reversed April's gains against the USD in May, falling 3.4% as an interest rate cut coupled with patchy Australian economic data was overrun by strong US economic data. The USD traded stronger against most currencies as softer than expected economic data increased expectations of an interest rate rise. The AUD fell 1.6% against the Euro.

In bond markets, domestic yields lifted across the curve over the first part of the month, only to reverse direction over the second half on a combination of weaker domestic data and flight to quality flows at the longer end on heightened fears that Greece would be unable to broker a deal with its creditors. Three and ten year government bonds yields peaked at 2.19% and 3.04% before ending the month at 1.88% and 2.73%. These moves meant that the Bloomberg AusBond Composite Index edged ahead by 0.04% over May. The cash sector, as measured by the Bloomberg AusBond Bank Bill Index, rose by 0.20% over the month.

Spot Brent crude oil consolidated with a 2.8% decline in May after a 21.6% rise over the course of the April. Iron ore experienced another strong month with a second consecutive month of gains around 9.0%. Base metals had a particularly difficult time in May, aluminium and nickel the worst effected, both falling over 10%. Spot gold fell 1.04% in the month.

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| Best/Worst Performers | | | |
|---|---|---|---|
| **(Best) company** | Month Return | **(Worst) company** | Month Return |
| James Hardie PLC | 20.9% | Caltex Australia Limited | -4.9% |
| JB HI-FI Limited | 11.5% | Dulux Group Limited | -5.5% |
| SAI Global Limited | 12.7% | Challenger Limited | -2.7% |
| Mayne Pharma Group Limited | 4.6% | Metro Performance Glass | -9.2% |
| Transfield Services Limited | 15.2% | QBE Insurance Limited (not held) | 6.9% |

| New/Increased positions | |
|---|---|
| Australian Finance Group Limited | New |
| Westpac Banking Corporation | Increased |
| ANZ Banking Group Limited | Increased |
| Macquarie Group Limited | Increased |
| Veda Group Limited | Increased |

| Exited/Decreased positions | |
|---|---|
| Carsales.com Limited | Exited |
| Isentia Group Limited | Exited |
| Commonwealth Bank | Reduced |
| National Australia Bank | Reduced |
| Mayne Pharma Limited | Reduced |

| Top 10 Holdings | | |
|---|---|---|
| **Stock name** | Trust weight % | Index weight % |
| ANZ Banking Grp Ltd | 8.9 | 6.1 |
| Westpac Banking Corp | 8.8 | 7.0 |
| National Aust. Bank | 7.2 | 6.0 |
| Commonwealth Bank. | 6.6 | 9.2 |
| Macquarie Group Ltd | 3.5 | 1.8 |
| Asciano Limited | 3.4 | 0.4 |
| AMP Limited | 3.3 | 1.3 |
| Mayne Pharma Ltd | 3.3 | 0.1 |
| Westfield Corp | 3.1 | 1.2 |
| Caltex Australia | 3.0 | 0.6 |

| Asset Allocation | | |
|---|---|---|
| **Sector** | Trust weight % | Index weight % |
| Energy | 5.3 | 5.1 |
| Materials | 10.8 | 15.4 |
| Industrials | 11.8 | 7.5 |
| Consumer Discretionary | 4.8 | 4.6 |
| Consumer Staples | 0.0 | 6.7 |
| Healthcare | 7.8 | 6.1 |
| Financials-x-Real Estate | 43.9 | 38.1 |
| Real Estate | 5.0 | 7.9 |
| Information Technology | 0.0 | 1.0 |
| Telecommunication Services | 2.4 | 5.6 |
| Utilities | 2.5 | 2.1 |
| Cash | 3.8 | - |

Rounding accounts for small +/- from 100%.

For all other enquiries please contact us on 1300 730 032
or visit www.perennial.net.au.

*Signatory of:*

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