Investment Market Update

Issue 48 – Spring 2012

Message from the Manager

Not sure if it's because I am getting older, but these quarterly newsletters sure come round fast.

It has been an extremely busy time at CIPL. Not only have we completed the mail out of quarterly and tax reports, we sold the Tamworth operations and have been negotiating on other opportunities.

We revamped the investment committee engaging the services of two very experienced investment experts whom I have known personally for many years – who would have thought I'd be employing my old boss!

CIPL's investment history traditionally, has been very sound, and continues to be so. In the recent Mercer survey, CIPL on average outperformed the best performing fund over a one year period, and was amongst the top performers over a three and 5 year period as well.

Read on for background on portfolio reviews, investment valuation, insurance and client service matters and some interesting stock picks.

David French
Managing Director
Senior Investment Advisor

Reviewing portfolios

The process

One question that comes up regularly is "how often do we review client portfolios?" The real answer is "continuously". Let me explain.

CIPL's investment committee meets monthly. The purpose of those meetings is to review our preferred stocks, and to incorporate the results of those reviews into individual portfolios. A lot of work goes into reviewing the preferred investments. Information is gathered from many sources, including company ASX releases, formal research reports, newspaper articles and journal articles. From this, the committee applies its experience and its own modelling to determine the relevance of the information.

Talking of experience, it's important to recognise the roles of the four members of the investment Committee:

- First and foremost, each committee member has real experience in investing their own money (as does many CIPL staff). That might sound trite, but unless people have real personal experience of the consequences of making investment decisions – specifically, what it feels like to gain or lose – it's unlikely they have developed the skills required to advise others (put another way, it's one thing parroting from a book, another completely to deal with the real world).
- Second, each committee member has a specific specialty to bring to the discussion. Sue for example is intimately involved with the day to day management of client affairs, so she knows the history and requirements of client relationships, Lachlan is very involved in technical analysis, which can be quite useful for picking short-term market movements, Michael Peet and Owen Evans are investment industry veterans, who spend all of their time investigating industries, companies and valuations.

Once a decision is made, we have to determine how it fits within specific client portfolios. It would be silly for example, to recommend selling a large holding, risking significant capital gains tax, if the overall benefit was modest. A small purchase of additional shares might be sensible if a stock has fallen in price for no apparent reason, and there is an opportunity to "average down" on the entry price. These things cannot be determined "en-masse" – it all depends on the individual portfolio.

On the other hand, sometimes there is good reason to treat all portfolios more or less equally. Some years ago we decided to sell Multiplex, which had doubled in price and was trading at around $6.00. The stock was priced for perfection and risks regarding Wembley Stadium were becoming apparent.

Level 2 Suite 1, 34 East St / PO Box 564 Rockhampton QLD 4700 Ph: 07 4920 4600 Fax: 07 4922 9069

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Recently we recommended selling a portion of Telstra shares for many clients. Telstra's competitive environment has changed significantly with the implementation of the National Broadband Network, and we felt that many holdings had too much exposure to Telstra. Some time ago we recommended selling all holdings in Tabcorp and Tattersalls (which had not performed well at all) for all clients and swapping into Queensland Rail (which has subsequently doubled in price).

Regardless of the rationale, all of these decisions are undertaken against a background of our knowledge of you as a client, and your risk profile, as reported to us in our original meeting (and which incidentally, we are updating now).

Valuation

Assuming we like a particular investment and we think it suits a client's portfolio, the question arises as to the appropriate price to pay. There are a number of ways to assess this, and each depends on the asset in question.

A highlight of my career occurred early in the peace, when I was selected to attend two valuation based courses in Hong Kong. These courses were run by Insead, one of the world's most respected business schools. The experience of the challenging math and the quality of the lecturing has stayed with me almost 20 years later, and cultivated a lifelong interest in valuation methods.

One of the best ways to value any investment (but unfortunately the most complicated), is discounted cash flow (DCF) analysis. There are a number of variations on this theme, but essentially DCF methodology involves estimating future cash flows and making an assessment of what someone would pay for those cash flows now.

Another commonly used method is known as a "multiple based valuation". Such valuations are based on multiples of profit (of which there are also a number of measures), or of revenues. A price earnings ratio is a simple example of a multiple based valuation.

Yet another method relates to calculation of net tangible assets – this can be very instructive if the price of an asset is consistently trading below its value if sold, or below the cost to build the underlying assets.

Hybrid securities and bonds are valued with respect to the yield to maturity, which is essentially the effective interest rate that applies when you purchase a particular bond, added to any capital gain that you might also expect (spread over the time period that you might hold the bond).

Sometimes a number of valuation methodologies are used in conjunction. To drive the point home, here are a few examples of applying the above analyses.

DCF's are calculated independently of the listed market price. By having a detailed look at the company and its earnings potential, we can assess the value of the estimated future cash flows. While we like to think we are clever and have some sort of monopoly on this insight, I am amazed at how many times a takeover bid comes in more or less right on the estimated value. That is, another company makes a takeover bid for a listed company, and the bid is priced at almost the same as indicated by the DCF. I can remember the takeover bids of Gibson Chemicals and Australian Chemical Holdings following almost that exact process (I did "from scratch" valuations on those stocks so I remember it clearly), and there have been many more. In the float of Alintagas Limited, the DCF suggested a much higher value than the share offer, and the stock turned into a top performer, and the same is true of Queensland Rail.

Multiple based valuations are much easier to complete, but they have one significant flaw – they are related to observed prices. We might say for example, that we would pay a multiple of 10 times earnings for a particular stock. If the market on average is trading at 15 times earnings, then 10 times looks cheap. Imagine if everyone wades in and buys the stock at 10 times earnings – the price will begin to rise. The rise in the stock price in turn pushes the market average up. Soon the stock is trading at 15 times earnings, but the movement in the stock price has meant the market now trades at 17x (say). So now we say anything under 17x is cheaper than the market, and everyone "piles in" to those stocks. You can see how this creates a self-perpetuating cycle – punctured in fact, when one of the components of the DCF methodology (described above) is changed (expectations of cash flows fall, interest rates go up, or risk levels increase). This is the story of the market's boom and bust, which in my opinion is accentuated by the use of multiple based valuations.

Valuation, based on net tangible assets, are not as common and have limited application to valuing industrial shares. Woolworths, trading at about $30, has very little in the way of net tangible assets. In contrast, the recent takeover bid for Australian Infrastructure Fund was very close to the valuation implied by its NTA, and underlines the observation that buying infrastructure and property assets at values below NTA is quite often a positive move.

It's also very useful to look at the "hidden extras" that you might pick up when making an investment. A great example is Brickworks, which is not only Australia's biggest brick and tile manufacturer, but which also has a significant land bank carried in its books at far less than market value. This is because old brickworks were often situated close to the edge of town. As cities grew the brickworks closed down, leaving a legacy of prime land in desirable suburbs. In many cases the value of this land has increased far beyond its carrying value, giving a free kick to investors who hold the stock as the land is sold. Clearly there are many facets to the effort that we apply to managing your portfolio. On top of what I have written above there are myriad administrative tasks, and the effort required to maintain cash balances and dividend expectations. Combined, these activities are core to CIPL's efforts. They are one reason why over time we have been able to consistently beat the All-ordinaries index. Indeed in the recent Mercer survey, CIPL on average outperformed the best performing fund manager (Investors Mutual) over a one year period, and was amongst the top performers over a three and 5 year period as well.

David French
Managing Director CIPL

Business Update

The big news this quarter is the sale of CIPL's Tamworth business. CIPL purchased the Tamworth business from Ray Griffin in 2009, and integrated its operations over the next year or so. Since 2010 Justin Baiocchi has managed that office, and with wife Liz has started a family – (just two of a number of little people CIPL has to its credit!). Unfortunately there have been few new clients presenting at the Tamworth business, and Ray and Justin saw an opportunity to take the business in a different direction, making an offer to buy it.

CIPL has a number of large projects in train, and the opportunity to sell Tamworth suited all parties. As at 1 October, CIPL will no longer run the Tamworth operations and we wish Justin and Ray well in their plans for the business.

The sale has meant that CIPL now has a debt free balance sheet, and an increased ability to complete some negotiations with parties regarding acquisitions and/or mergers. The momentum of the company's consulting arm is gathering strength, and a number of larger business improvement and valuation based jobs are in hand. We look forward to sharing the outcome of these discussions with you as negotiations are finalised.

Many clients will know that CIPL is redeveloping the old Grand Hotel site as part of the Capricorn Diversified Investment Fund. A Heads of Agreement has been signed with a major tenant, and following a tender process builders are close to being appointed. We expect to have more information on this exciting development in the near future.

Insurance Matters

Do I already have insurance?

There is a good chance you already have insurance cover and it's important to regularly review this to ensure you have the best you can get. In doing so you may discover that you are already well covered or you might find out you have too much cover. What's important is getting the right cover.

Here are two simple steps you can take:

Check your superfund

Most Australians have at least one super fund and, by law, super fund trustees must provide a minimum level of automatic insurance cover for members. Premiums are normally deducted from your super contributions.

The first step you should take therefore is to check with your super fund(s) and see what cover you may have in place. But remember the level of cover automatically provided to members is unlikely to be exactly what you and your family need. Don't worry though; it may be quite easy to adjust your level of cover so that it is more appropriate for your needs.

If you have more than one super fund and have life insurance with each of them, it might be worth thinking about consolidating the funds. It's a good idea to look at the investment performance of the fund, the fees charged and, of course, the level and type of insurance benefits you have available before making any decision.

If you think you have lost a super account, the Australian Taxation Office (www.ato.gov.au/superseeker) can help you find your lost super.

Check with your employer

Some employers have insurance in place for all of their staff, either through their superfund or through a separate stand alone insurance scheme. This means that your second step should be to talk to your employer about whether they have any insurance in place.

This is fast becoming a popular employment benefit offered by employers.

Because these insurance arrangements are specifically designed for employees you may also find you are covered by total and permanent disability insurance, income protection and even trauma insurance, in addition to Life Insurance cover.

Jason Fagg
Life Risk and Financial Advisor

Investment Briefs

Corporate actions for the October quarter

DCG: There has been much coverage in the media over the last few months about the apparent slowdown in the global mining sector. It has been interesting to watch the effect this has had on the Australian public, who it appears, now view the mining sector in a binary light – boom or bust. This is far from reality and what we have seen occur recently, is the dual effects of a slowing global economy combined with increasing supply being brought on stream as new mineral projects are developed.

Decmil Group (DCG) is a company we have liked for some time and is our premier stock within the non-producing resources sector. DCG's main operations are the building of housing for mining workers on site as well as other infrastructure related mining work. DCG has seen demand for its services grow strongly over the last number of years due to the increasing demand for onsite accommodation. DCG reported a stellar result in FY12 announcing a 66% increase in NPAT with EPS higher by 40% to 26.5 cps. Importantly management stated that the outlook continues to be strong with a solid pipeline of projects supported by a total order book of around $400m.

Recently DCG made a full acquisition of the Calliope Village near Gladstone. We see this as a good move by management as it increases the recurring revenue the group earns as well as increasing the group's stake in an area which is important to the Curtis Island LNG Operations. Importantly DCG has very solid operating cash flows, no debt and $141m in cash.

APA: For those newly acquainted with APA Group (APA) you may have first become familiar with the group due to the ongoing takeover of Hastings Diversified Fund (HDF). APA owns Australia's largest gas distribution and storage network and is currently in the process of acquiring HDF, the owner of the very lucrative EPIC Energy in South West QLD. APA is a preferred investment due to the stable nature of its cash flows and due to the regulated nature of the gas distribution industry.

In itself, we see APA as a good investment due to the solid 7.1% dividend yield on offer, a distribution which is covered by free cash flows. Investors have seen this dividend steadily increase over time and we expect it will continue to do so in the future. However, the main potential is seen from the acquisition of HDF. Normally price increases in gas distribution contracts are derived by taking CPI and subtracting a locked in 'X' factor. In the case of HDF's Eastern-haul EPIC contracts, price increases are more closely aligned with CPI. This is potentially a significant bonus and one of the main drawcards for APA.

In a lower yield environment with the prospect of further declines in the cash rate, we see APA as a good place to invest to increase the yield profile of portfolios. Although there is some uncertainty with the outcome of the HDF acquisition we see the clear benefits of APA owning the business providing for increases in free cash flows and as a result dividends into the foreseeable future.

ALQ: Formerly known as Campbell Brothers (CPB), ALS Ltd. (ALQ) is involved in the testing and analysis in a diverse range of industries such as minerals, metallurgy, coal, food and pharmaceutical. The company is one of the oldest on our exchange and has reported profit growth in the last 10 consecutive years (with the exception of 2010). ALQ has certainly been one benefactor of the recent mining boom with a surge in demand for its specialised minerals testing capabilities. However, this has recently been a curse for the company in terms of sentiment. The share price is down 35% on the back of fears of further contraction in resources activity.

At ALQ's recent AGM, some cautious market commentary resulted in further falls in the share price. However, it appears the market has overlooked the fact that although minerals comprise a significant component of revenue (49%), 51% is derived from the non-minerals sectors of which 44% comes from industrials and life sciences. The latter two categories should prove to be relatively resilient and although there is some uncertainty over the medium term future of minerals. It is encouraging to note that the group is spending $80m on capital expansion, a clear sign management are expecting volumes to continue rising.

ALQ comfortably meets all important criteria as an investment. Return on equity increased significantly in FY12 to now be 24%, EBITDA margins are just shy of 27%, the group has very solid cash flows (free cash flow yield of 4.6% not inclusive of acquisitions) and although the group has some debt (39% gearing) it comfortably meets these interest requirements by 21x. The company can be purchased for 14x FY12 earnings which at first may sound a little expensive however, we believe the company deserves a premium due to it enviable track record of delivering value to shareholders. Furthermore, in light of the recent fall in share price the group now offers a partially franked dividend yield of 5%.

Lachlan McKenzie - McHarg
Equities Advisor & Dealer, and

Bob Stewart
Senior Advisor

Level 2 Suite 1, 34 East St / PO Box 564 Rockhampton QLD 4700 Ph: 07 4920 4600 Fax: 07 4922 9069
enquiries@capinvest.com.au or visit www.capinvest.com.au
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Client Services Update

Have your contact details changed?

It is important that all contact information for CIPL clients is accurately maintained in our system to ensure quarterly and tax reports along with any other important correspondence is sent to the correct email or postal address, and that we can contact clients by phone or mobile when necessary.

If you have changed any of your contact details recently, including your postal address, email address, mobile or landline numbers, please contact us on enquiries@capinvest.com.au or phone 1800 679 000 to update your information.

Receiving your information electronically

Did you know you can receive all of your correspondence from Capricorn Investment Partners Limited by email?

This includes quarterly and tax reports, seminar invitations, newsletters and recommendations which means you can have your reports as soon as they are processed in our system rather than waiting a week for snail mail. It's beneficial to respond to recommendations as quickly as possible due to their time sensitive nature, therefore opting for the electronic correspondence and accepting them using the client portal is by far the most time efficient way to action recommendations. We can also email your reports direct to your tax accountant if requested.

If you would like to opt for any of the above options please simply phone 1800 679 000 or email enquiries@capinvest.com.au to let us know.

Our long standing service of posting out reports and correspondence will always be available for those clients who prefer to receive their information in hard copy format.

Client Portal

Would you like some extra help using the client portal? We have staff available to help you in accessing your information online, changing usernames or passwords or simply running or accessing reports. Whether you're brand new at using a computer or well versed we can run you through the parts you need to know. We're here to help you however we can. You can opt for some help at the end of your client review throughout the year or over the phone. Feel free to give us a call between 8:30am and 5:00pm weekdays.

Prepayment of Annual Fees

Don't forget you are entitled to a 10% discount on your yearly fees if you decide to pay in one transaction. Please call 1800 679 000 or email enquiries@capinvest.com.au if you would like us to calculate your discounted fees for you to review. This can be done at any time throughout the year.

Our Services

At CIPL we offer a range of services to meet the needs of all of our clients. Our services include:

- Financial Planning
- Life Insurance
- Deposit Broking
- Small Business Consulting
- Share Trading
- Capricorn Diversified Investment Fund (CDIF)

If you need to revisit any of the above services please send us an email to enquiries@capinvest.com.au or call us on 1800 679 000 to make an appointment.

Word of mouth

We'd like to extend a huge thank you to those clients who have recommended our services to friends and family. Word of mouth is by far the best form of advertising for our business and we're always delighted to hear about it when we've met all of your expectations.

On the flip side we're also eager to hear how we can improve our services. Please keep the lines of communication open so we can continue to grow our customer relationships and provide you with the best service possible.

Rose Sladden
Client Services Manager

The content of the newsletter constitutes general advice and does not take into account your particular needs. Please seek appropriate advice before acting on anything contained herein.

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enquiries@capinvest.com.au or visit www.capinvest.com.au
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Your team at Capricorn Investment Partners Limited


David French
Managing Director


Michael Blanchflower
Head of Strategy (Sydney)


Sue Dunne
Financial Advisor


Bob Stewart
Senior Advisor


Lachlan McKenzie-McHarg
Equities Advisor & Dealer


Jason Fagg
Life Risk Advisor


Roger Cameron
Financial Analyst


Kathy Donaghey
Portfolio Administrator


Ben Scott
IT Manager


Bronwyn Nunn
Compliance Manager


Rose Sladden
Client Services Manager


Jaimi Summerton
Reception/ Administration Support Officer


Christine King
Bookkeeper

CHART PACK

***Information at a glance** (Reuters, NAB)*

China Inflation Rate

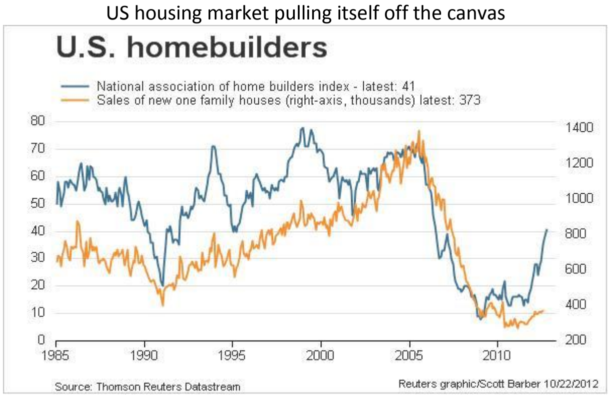
New Government has headroom to implement further interest rate reductions

US 10 Year Treasuries

Re-emergence of risk on and movement into equities with a recent fall in US treasuries

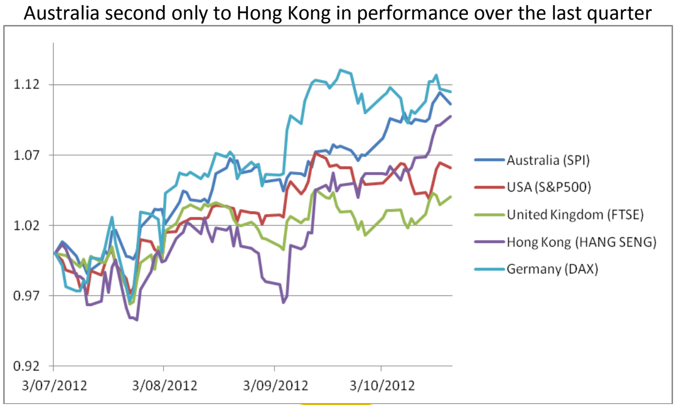
US Homebuilders

US housing market pulling itself off the canvas



Share market performance comparative

Australia second only to Hong Kong in performance over the last quarter



Level 2 Suite 1, 34 East St / PO Box 564 Rockhampton QLD 4700 Ph: 07 4920 4600 Fax: 07 4922 9069

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