# Freehold Absolute Return Fund

## Report for the month of January 2015

### Fund Overview

The **Freehold Absolute Return Fund** takes long and short positions in securities exposed to assets such as office and industrial real estate, residential development, retail shopping centres, airports, ports, toll roads, rail and utilities.

### Investment Objectives

- Generate returns of between 12 - 15% per annum over rolling three year periods
- Target portfolio volatility of less than 15%

### Average Fund Statistics for January 2015

| | |
|---|---|
| Number of positions: | 10-15 |
| Net Long: | ~40% |
| Total Long Positions: | ~60% |
| Total Short Positions: | ~20% |
| Gross Exposure: | ~80% (longs + shorts) |

## Fund Performance

| | Jan | Feb | Mar | Apr | May | Jun | Jul | Aug | Sep | Oct | Nov | Dec |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| **2013** | | | | | | | 0.52% | 4.22% | 2.79% | 2.14% | 1.93% | -0.19% |
| **2014** | 0.57% | 1.01% | 1.21% | 1.69% | 1.71% | 1.34% | 1.80% | 1.75% | 0.36% | 1.73% | 0.81% | 3.22% |
| **2015** | **1.49%** | | | | | | | | | | | |

| Performance | |
|---|---|
| **Rolling Quarter** | 6.12% |
| **Rolling 12 month** | 22.14% |
| **Since Inception** | 34.70% |
| **Observed Volatility** | ~4.6% |

### Fund Profile

| | |
|---|---|
| Trustee: | Freehold Capital Partners Pty Ltd, AFSL 344 188 |
| Major Shareholders of Trustee: | ASX listed Treasury Group (TRG) and Freehold Executives |
| Fund Managers: | Tim Hannon and Andrew Smith |
| Firm Funds Under Management: | AUD $280 million |
| Prime Broker and Custodian: | UBS AG |
| Administrator: | Citco Fund Services |
| Middle Office: | Mainstream BPO |
| Auditors and Tax: | PricewaterhouseCoopers |
| Legal: | DLA Piper Australia |
| Regulator: | Australian Securities and Investment Commission (ASIC) |

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Freehold Investment
MANAGEMENT

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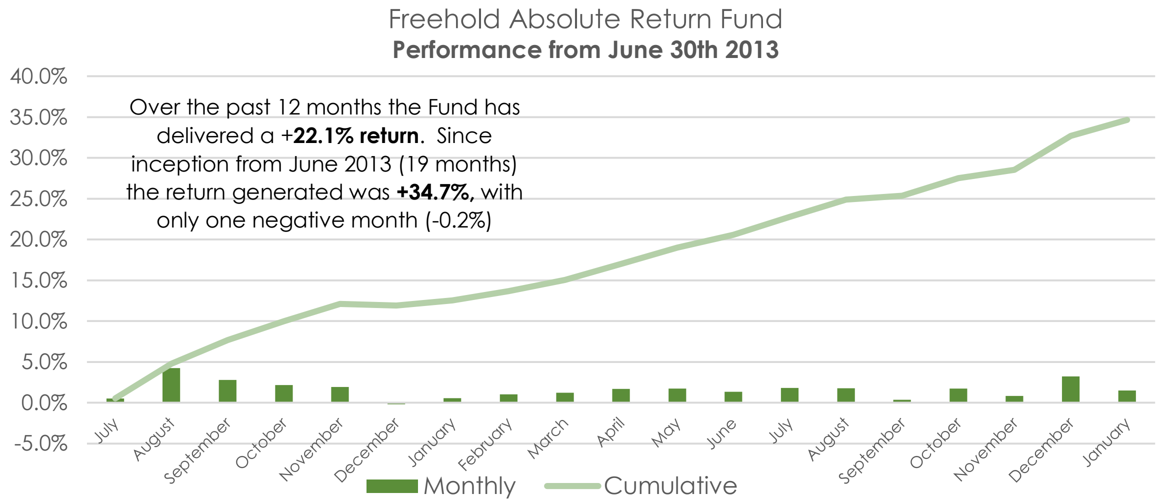
## Fund Commentary

The Fund delivered a **+1.49% performance over January** as we witnessed continued strength in global real estate and infrastructure markets.

### Fund returns remain solid, with low levels of volatility…

The Fund continues to deliver **solid returns** with **low levels of volatility**, the chart below highlights this:




## Market Commentary

Since the RBA cut interest rates early February to a record low 2.25% numerous market commentators have strongly reinforced the benefits of the very popular **'yield trade'**. The argument is that for investors to generate sufficient income they have to move up the risk curve, **switching out of cash** and buying '**high yielding' Australian equities.**

It is worth noting that 'yield stocks' have already been **massive outperformers this year.** The sector performance for the ASX200 year to date is REITS +10.9%, Utilities +9.7%, Financials +9%, Telecommunications +8.3%, Discretionary +7.6%[1]. **These are abnormal returns.**

### Just because cash is not 'high returning' does not mean it is not valuable…

A major assumption regarding the attraction of the 'yield trade' is cash is an impaired asset class because it is earning such a low return.

We strongly disagree. Despite cash providing little return, it provides an **optionality** that has value.

Warren Buffet for example, thinks of cash as a call option over every asset class and with no expiration date.

The question Buffet asks is "how much can the cash return if I have it when I need it to buy other assets that are cheap, versus the upfront cost of holding it?[2]". Nassim Taleb, author of The Black Swan also highlights that the optionality of cash allows the holder to buy assets from people who are over exposed when a crisis hits.

*"Let's assume that you have cash in the bank and there's a big crisis. You have dry powder. You can buy anything you want. **Cash is the opposite of leverage**.[3]"*

**Conclusion:** Despite cash returning little in real terms, **it still has value in a diversified portfolio**

[1] Moelis and Company
[2] The Snowball, Warren Buffett and the Business of Life, Alice Schroeder, 2008
[3] The Black Swan, Nassim Nicholas Taleb, 2008

### Desperately seeking yield…

As part of the 'yield investing' mantra it seems that there is an overt focus on '**next year's dividend yield**'[4], with many investment houses promoting a list of their 'top five yield stocks', which are ranked by the size of the dividend yield they deliver.

We caution that investors should be concerned about a lot more than just next year's dividend yield. As investors, we are concerned about:

1. The **current dividend level**
2. Dividend **sustainability** or **risk**
3. Future dividend **growth**

Overall, we fundamentally believe that an investor should be concerned with whether the company is **creating shareholder value over the medium to long term**. A company's portfolio of tangible and intangible assets should be working together to generate a return on invested capital greater than the company's cost of capital. The best business to own is one that over a long period of time can employ large amounts of incremental capital at very high rates of return, this will **drive both future dividends and capital growth.**

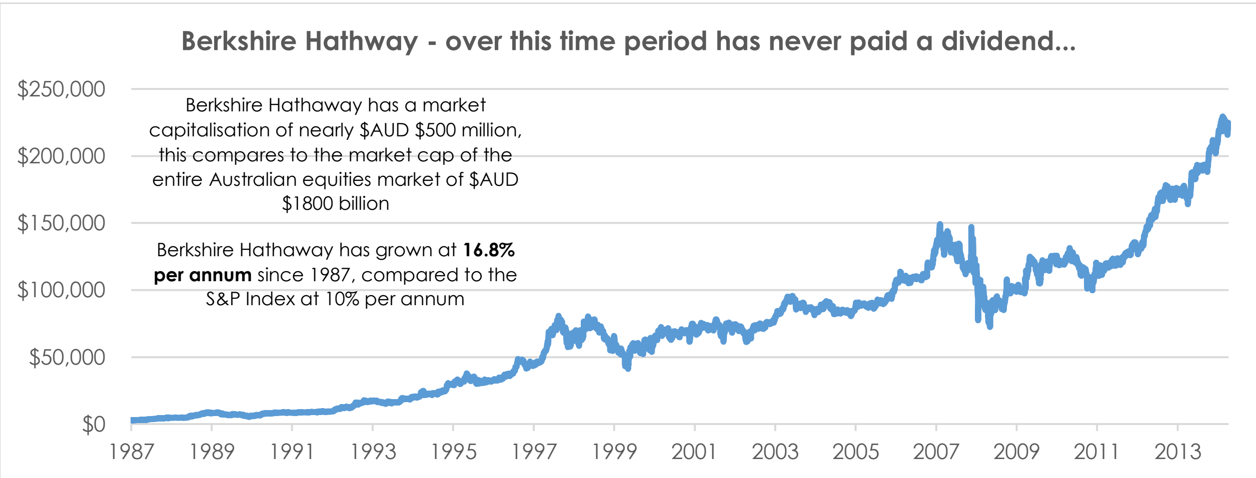
### Are dividends irrelevant?

There is a body of academic work that suggests **firm value is independent of dividend policy**[5]**.** The research states that it makes no difference if a firm retains all earnings for reinvestment into the business or pays all earnings out as dividends and then uses equity and debt to fund future company investment.

To highlight an extreme example, we highlight Warren Buffet's primary investment vehicle, Berkshire Hathaway, which **pays no dividends.** Buffet prefers to reinvest earnings back into the business to earn excellent returns.

**"Our shareholders are far wealthier today than they would be if the Funds we used for acquisitions had instead been devoted to share repurchases or dividends"**

**Warren Buffet, Berkshire Hathaway letter to investors, March 1st, 2013**




Buffett states not paying dividends is better both for shareholders and the firm, by allowing individuals the flexibility to extract the right amount of cash for them in the right circumstances, while leaving the business free to invest in itself. If shareholders want income, he argues, **they should sell a portion of their shareholding.**

[4] Next year's dividend yield is the company's next forecast dividend divided by the current share price

[5] See: Modigliani and Miller, 1961

### But dividends do matter, particularly in Australia…

Despite there being research to suggest that dividends are irrelevant to firm value, there is also plenty of work to highlight **just how important dividends are.** As John Burr Williams wrote in his 1938 book, *The Theory of Investment Value:*

"If earnings not paid out in dividends are all successfully reinvested at compound interest for the benefit of the stockholder…then these earnings **should produce dividends later**"

- In Australia, dividend imputation[6] incentivises firms to pay out valuable **'franking credits'**. If the firm requires capital to reinvest in their business, they should raise equity or debt capital to do so. After dividend imputation was introduced in 1987 dividend payout ratios jumped from 47% to 76% over the ensuing three years[7].

- There is a plethora of academic research to show that high dividend payouts **signal higher future earnings growth[8]**. Increasing dividends is a high quality method for a company to signal to the market a positive view of the future.

- Maybe scepticism of management is the reason for the yield bias? We can understand why investors enjoy looking at the existing dividend yield. The sustainability and future dividend growth **is not directly observable,** and requires a high quality management team to deliver it - which does not always occur.

**Conclusion**: <u>Dividends do matter</u>, but **must not be the sole focus** – investors should also focus on the risk or sustainability of the earnings that are creating the dividend, as well as the potential for future growth.

### REIT and Infrastructure distributions

We are becoming concerned that the distribution yield of the REIT and Infrastructure sector is becoming too compressed, and not taking into account the risk of future earnings. On balance, it seems clear that it is **lower bond yields** that is driving demand for 'yield securities', we think the primary risks from here are twofold:

- REITs and Infrastructure securities do not deliver on the earnings front due to deteriorating fundamentals

- Bond yields gap up 50-100 basis points, causing at 10-20% decline in share prices.

We expect the key risk is bond yields rising. The market is not expecting this, but if we get a situation were short term rate cuts see the market begin to predict a recovery in Australian economic growth, long term yields will rise and 'defensive' REIT and Infrastructure securities would sell off heavily.

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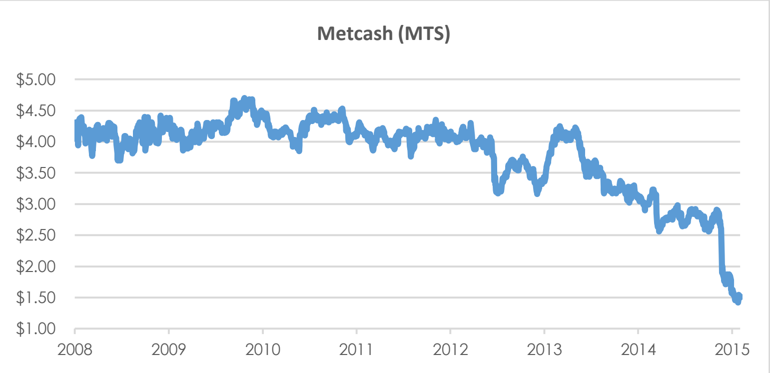
[6] Australia differs from the major US market with our dividend imputation system. In the US, there is double taxation; the profit of a corporate is taxed, and then any dividend paid out to investors is taxed again. In Australia, this tax is paid just once. Assuming a corporate tax rate of 30%, and a marginal tax rate for an investor of 30%, this makes the **dividend tax free**. This is clearly the reason why payout ratios are so much higher in Australia than the USA and other major global equity markets.

[7] Dividend Policy, energy utilities and the investment megacycle, Simshauser and Catt, 2011

[8] See Bhattacharya, (1979) and Miller and Rock, (1985)

### Case Study: Example of a 'dividend' stock going awry…

Metcash was historically considered a 'yield security' – generating an 'attractive' fully franked yield of 7% in 2012. Structural issues within the company saw earnings continue to decline and despite lobbying from shareholders not to cut the dividend, the dividend was cut sharply.




**Metcash (MTS)** is a retail wholesaling business. Metcash's customers are, predominantly, independently owned grocery and liquor stores,

**Severe competitive pressures** in its core grocery business has seen earnings **more than halve** over the past few years and dividends fall in line with this reduction. MTS was paying dividends by increasing debt but finally succumbed to the fundamentals - dividends were 28 cents per share in 2012 and are forecast to be cut to 13 cents by 2015.

## Interest rate driven earnings upgrades…

The benefit of falling interest rates is significant for the real estate and infrastructure sectors:

- An **increase in valuation** on the back of lower risk free rates used in valuations
- Earnings upgrades due to **lower interest expense**

### Earnings upgrades from lower interest expense

We have already seen lower interest expenses lead to three REITs declaring earnings upgrades – GPT Group (GPT), 360 Capital Office Fund (TOF) and Australian Industrial REIT (ANI). **We believe this will be a key feature of the upcoming reporting season.**

Real estate and Infrastructure securities are highly capital intensive, and heavy use of debt is made to control them. The average real estate company has leverage (debt to total assets) of ~ 35%, whereas the average industrial company has leverage of under 20%[9].

To illustrate the effect of lower interest expense, we illustrate with an example below of a generic real estate company re-setting their interest rate to current market rates.

The five year bank bill swap rate (this is the rate at which the banks can borrow at) has fallen from 3.5% to 2.5% over the past 12 months. On top of this decline to that, the margin that real estate and infrastructure companies pay over this rate has compressed from 1.7% to 1.2%[10]. Overall, we estimate **debt costs may have fallen from 5.5% to 4%.**

| Interest Rate of 5.5% | | Interest Rate of 4.0% | |
|---|---|---|---|
| **Base Scenario** | | **Lower interest rate scenario** | |
| Net Income | $2,000 | Net Income | $2,000 |
| Assets | $30,000 | Assets | $30,000 |
| Debt | $10,000 | Debt | $10,000 |
| Leverage | 33.3% | Leverage | 33.3% |
| **Interest expense** | **550.0** | **Interest expense** | **400.0** |
| Earnings post interest expense | 1450.0 | Earnings post interest expense | 1600.0 |
| Shares on issue | 100.0 | Shares on issue | 100.0 |
| **Earnings per share (EPS)** | **$14.50** | **Earnings per share (EPS)** | **$16.00** |
| **Earnings per share upgrade** | **10.3%** | | |

As we can see, the generic real estate company example sees a ~10% earnings upgrade from lower interest expense.

Across the universe of real estate and infrastructure securities, the winners are likely to be Novion (NVN), Abacus (ABP), Stockland (SGP) and Goodman Group (GMG). We forecast ~6% -12% earnings per share accretion from lower interest expense for these names.

Whilst these are significant moves and could very well provide short term share price upside, we caution against putting too much value on earnings upgrades generated from lower interest expense – **how sustainable are these earnings**?

[9] Source: Bloomberg
[10] Source: Australian REITs, 2015 Outlook Report, JPMorgan, January 2015

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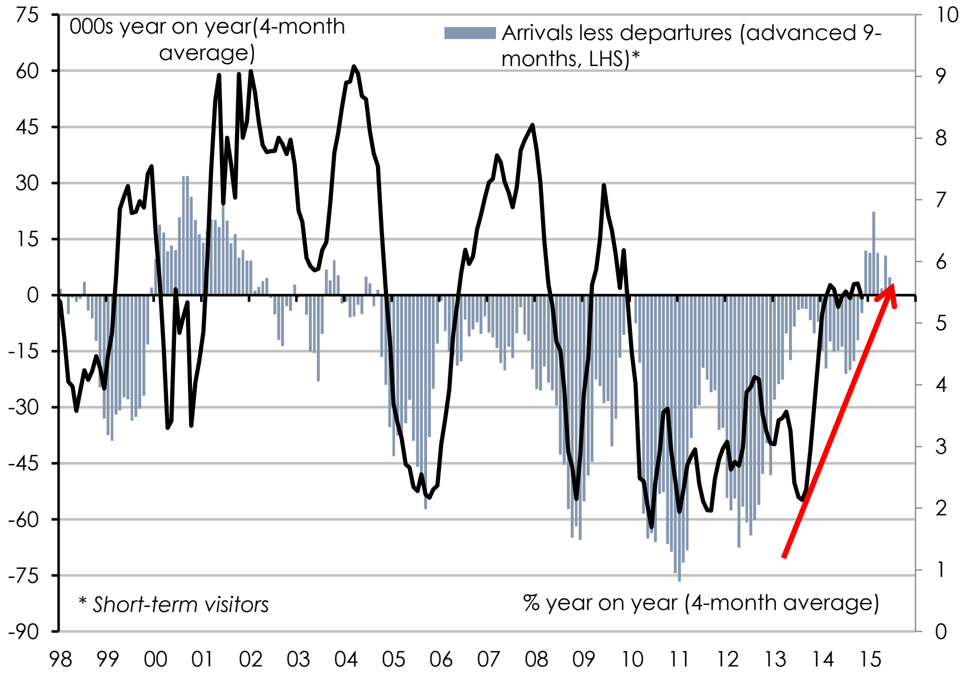
## The retail sector

There are a number of **tailwinds** for the retail sector at the moment:

- **Petrol prices have decreased**, 2-3% of household disposable income is spent on petrol, the recent fall has been estimated by Deutsche Bank to be the equivalent of 50 basis points in rate cuts[11]

- **Mortgage Rates have decreased,** further increasing household disposable income

- The **Australian dollar has fallen**, meaning less outbound travel and more inbound travel. The chart below highlights this phenomenon, as net arrivals increase, Australian retail spending increases




Retail sales moves higher because the lower Australian dollar sees more tourism in Australia.

Data and Chart sourced from UBS Australia

### But watch for the increase in cost of goods sold…

Despite the likelihood that retail sales will increase, the Australian dollar falling also can cause problems for retailers. Because approximately **75% of all goods are purchased offshore**[12], retailers and wholesalers will be paying more for their goods. This is not an issue if they are able to increase their end prices, but the risk is that the **strong competition** in Australian retailing will see them unable pass on the full price rises necessary to maintain their margins.

It is still unknown whether or not retailers can increase prices or not, but anecdotal evidence so far does not appear positive:

*"Zara Australia has turned up the heat on domestic retailers by **vowing to maintain prices** despite a 17 per cent fall in the dollar in the past five months. Zara's plan to keep Australian prices on hold **will limit the ability of domestic suppliers and retailers to raise prices** across the board to recoup the cost of importing stock from countries such as China, India, Vietnam and Bangladesh. Global chains such as Uniqlo, H&M and newcomer Forever 21 are likely to follow Zara's lead"*

**Australian Financial Review, January 2015**

[11] Sydney Morning Herald, January 30th, 2015
[12] Australian Productivity Commission, 2011

# Freehold Absolute Return Fund

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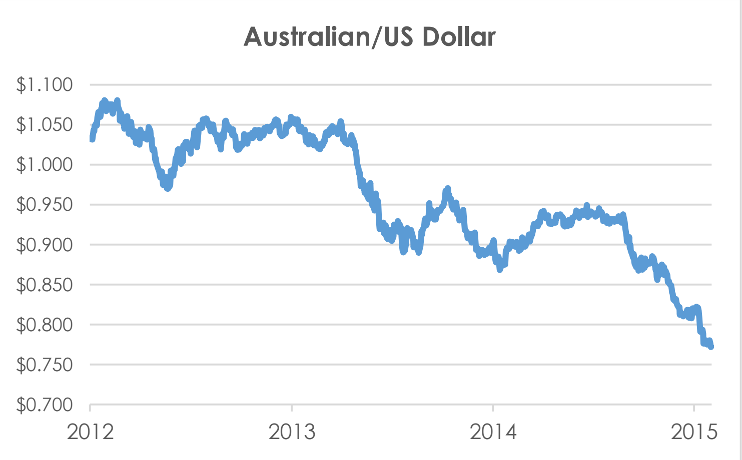
### What is the risk?




The majority of retail imports into Australia are priced in US dollars.

Versus the US dollar, the Australian dollar has fallen **nearly 25%** over the past few years.

Retailers generally have hedging in place, so they are protected in the short to medium term from falls in their purchasing power. Nonetheless, at some stage, the hedging rolls off and retailers and wholesalers will be paying substantially more for their goods.

The example below shows the potential margin compression of a typical apparel retailer that sources their product 100% directly from offshore.

| Apparel Retailer | AUDUSD at $1 | AUDUSD at 75 cents | Comment |
|---|---|---|---|
| **Sales** | **100.0** | **105.0** | Sales increase by 5% due to positive retail tailwinds |
| | | | |
| Cost of Goods Sold | 40.0 | 53.3 | Cost of Goods Sold rises from $40 to $53 , a massive +33% |
| **Gross margin** | **60%** | **49%** | Gross margin declines because prices are not increased |
| Gross profit | 60.0 | 51.7 | Gross profit declines by 14% |
| | | | |
| **Costs** | | | |
| Labour | 24.0 | 24.6 | Labour rates increase by inflation |
| Advertising | 2.0 | 2.0 | Advertising remains flat |
| Utilities etc | 3.0 | 3.1 | Utilities increasing at inflation |
| Rent | 19.0 | 19.0 | Rents flat (albeit retail landlords try to increase) |
| **Total Costs** | **48.0** | **48.7** | **Fixed costs increase marginally** |
| | | | |
| **EBIT** | **12.0** | **3.0** | |
| **EBIT Margin** | 12.0% | 2.9% | **Retailer moves to being barely profitable** |

As can be seen from this example, in the extreme event that a retailer is unable to lift prices, profitability is materially impacted.

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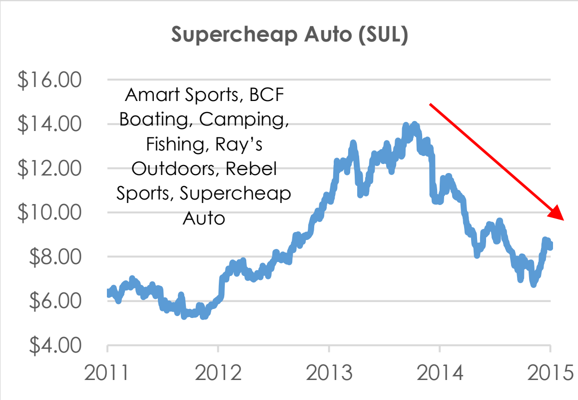
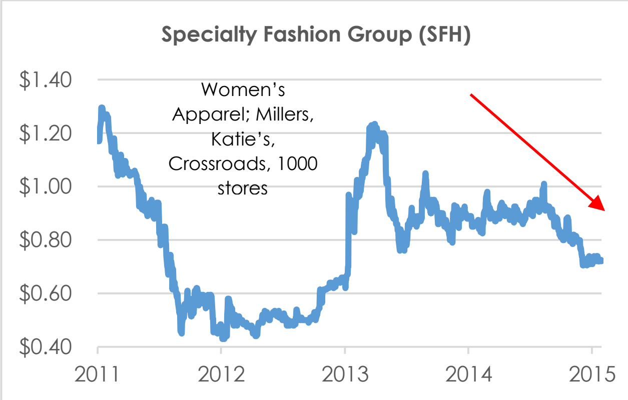
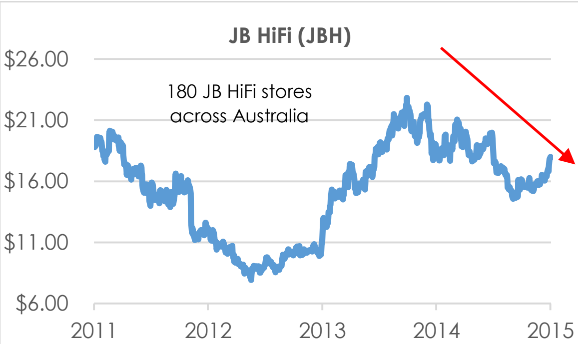
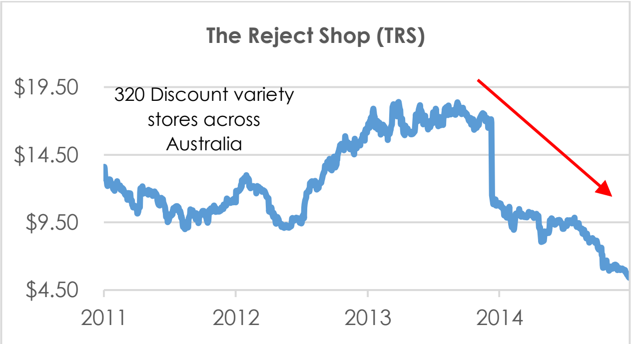
### Australian retailers are generally not in a good place…

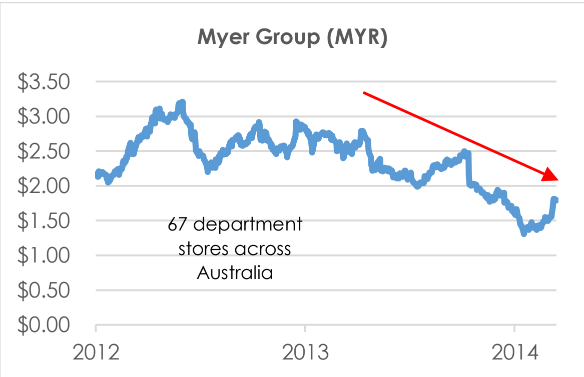
Generally, retailers are not performing as rents and wages increase faster than the end prices of the goods that they sell.

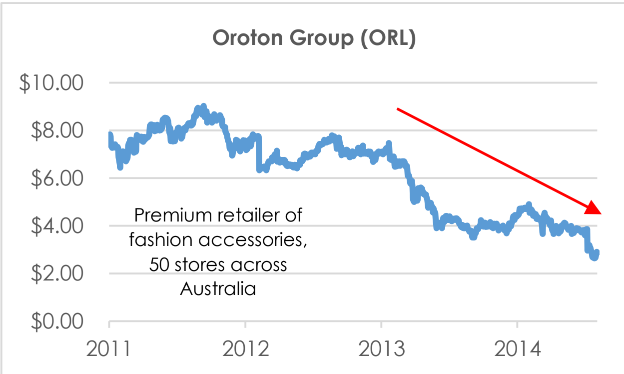



## Conclusion

Overall, despite retail sales growth likely to be stronger over the next 12 months, we are sceptical of the ability for retail landlords to increase rents given the pressure retailers are likely to be under. We will be watching closely during this reporting season for any evidence of retail landlords using their balance sheet to shore up occupancy. This is normally in the form of incentives, where a retailer is given a 'rent free period' or some capital contribution to their fit out. This use of incentives can make the operating metrics of a retail landlord (particularly occupancy) appear much better than the actual fundamentals.

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## Key Attributes of the Fund

- Returns largely independent of rising or falling bond or equities markets
- Skill based income stream – minimal correlation with equities markets
- Specialised sectors with characteristics materially different to broader equity sectors, but sometimes treated in the same fashion – regularly creating market mispricing

## Fund Details

- The investment managers will have a significant portion of their personal wealth within the Fund
- Monthly and quarterly reporting from the manager on Fund performance
- 1.5% base fee with 20% performance fee over a **bond rate hurdle**