

BKI Quarterly Report



A few thoughts for 2018

Welcome to the 17th edition of the BKI Quarterly Report, prepared by Contact Asset Management. As we approach the end of the year, we wish you and your families a safe and happy Christmas. Thank you for your continued support.

In this edition we consider a few issues that are front of mind as we look into 2018 and beyond. We don't intend to try to make a market prediction as to where we'll be in twelve months – that's too short a time horizon for us! Nevertheless, there are a number of interesting dynamics in our market that we think will dominate headlines in the coming year. We share our thoughts on a few of these below.

What are the big themes for 2018 that are dominating headlines?

As we wade through a number of research reports in recent weeks, it appears that the common themes for 2018 globally are:

- Expectations of a sustained pick up in global growth
- It is anticipated that the US Fed will lift interest rates three or four times
- The pace of growth in China will continue to slow, albeit at a measured rate
- Bitcoin: a bubble or are we all missing something?

Domestically, the major areas of focus going into 2018 include:

- The Royal Commission into the Australian banking system
- The volatile political environment
- The National Broadband Network and the impending arrival of 5G
- A pick up in Australian GDP growth
- The Energy debate and the rising impost of energy prices on Australian businesses
- The arrival of Amazon
- Interest rate movements—which are not expected to take the same trajectory as the US

We cannot offer a lot of insight into the Bitcoin argument, other than to rehash a comment we read on LinkedIn recently, which stated:

"I don't like Bitcoin for two reasons:

- 1) I don't get it*
- 2) I don't have any."*

On a more serious note, we are watching the developments in this space and innovations arising from it. For example, ASX Limited (held in the BKI portfolio) recently announced its intention to replace CHESS with distributed ledger technology to manage the clearing and settlement of equity transactions.

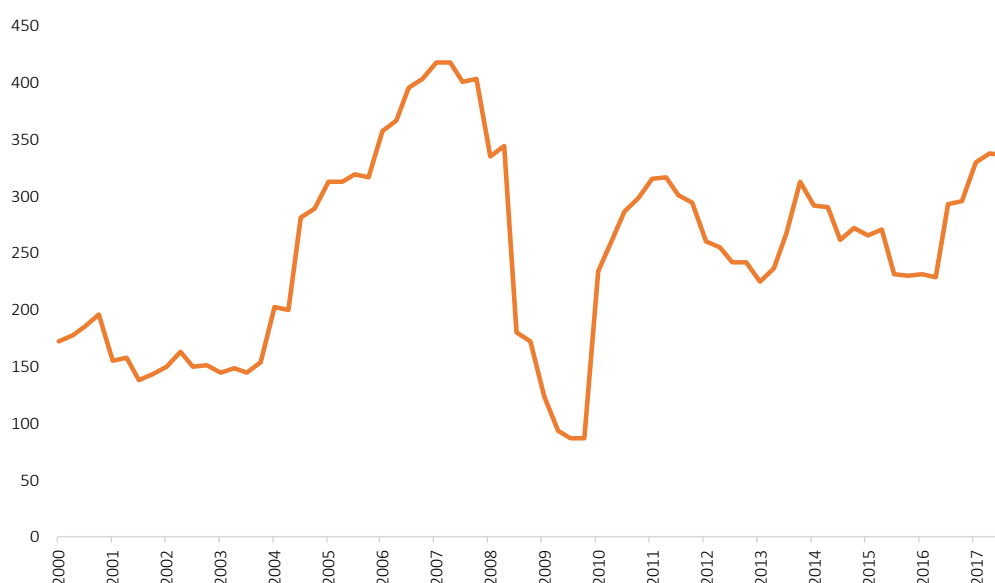
2017 was the biggest year-on-year rise in Australian earnings per share since early 2011.

The Australian Equities Market

The strategists at the major Broking Houses are out with their predictions for the Australian share market in 2018. While many note that valuations are stretched, no one is calling a negative return in 2018. Earnings growth momentum was very strong in 2017 (the chart below highlights this) and generally results seasons were upbeat. Most expect this to continue and several strategists are predicting that the S&P200 Index will be 6500 by Christmas 2018 – almost a 10% increase in capital gain with another 3%-4% when one allows for dividend income. Given a very solid bull market for Australian Equities in recent years, we think that expectations of a 14% total return are too optimistic.

S&P/ASX 200 Index: Earnings per Share (12 months rolling)

2017 was the biggest year-on-year rise in Australian earnings since early 2011



Source: Bloomberg

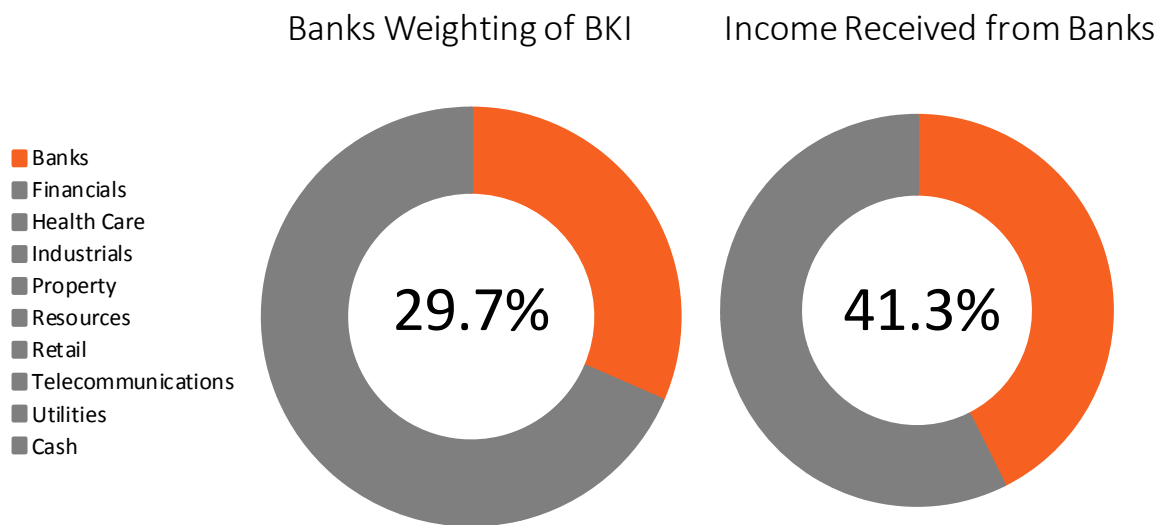
It is hard to know how much faith to put in the Strategists' forecasts. For example, this time last year, the strategists surveyed by Barron's (in the US) were looking for just 5% gains in 2017. The Dow Jones has delivered 22% and the S&P500 has delivered 18% in the year to date.

Which is why we prefer a bottom up approach at BKI. That is, we'd rather weigh up the merits of individual stocks and look for those that will do better than their peer group regardless of what the macro environment may serve up.

We do not blindly ignore certain industry or macroeconomic issues. In fact, we are encouraged by a number of economic indicators, notably the low unemployment rate in Australia, the expectations for sustained population growth and the outlook for public infrastructure expenditure.

The Royal Commission into the Australian Banking Industry

The Banks make up a significant proportion of the BKI Investment Company Portfolio, both in terms of overall portfolio weight and income generation. We used the following chart in the August 2017 results presentation to highlight the important role that the major banks play in providing income for Australian portfolios.



Therefore, the announcement of a Royal Commission into the Banking sector is an important one for BKI shareholders. This is what we know so far:

- Prime Minister Malcolm Turnbull noted that the Royal Commission *"will cover the nation's banks, big and small, wealth managers, superannuation providers, insurance companies. It will be a comprehensive inquiry."* The investigation has the power to summon witnesses and take evidence. It doesn't have the power to order compensation be paid to any consumers who have been negatively impacted. However, in its final report, it can make recommendations for the Government to consider, which could include changing legislation.
- The Royal Commission has 12 months to complete the enquiry, with a final report expected to be delivered on 1 February 2019.
- It will be expensive – Citi Investment Research believes that the total cost for the seven banks will top \$1 billion—and we expect that all will bear the brunt of this cost—shareholders, customers and tax payers.

Our assessment is that while the Royal Commission will be a significant distraction for management, the scope of the Commission is not as bad as many feared. It seems likely that business models may need to change slightly, with Wealth Management likely to be a focus. However, many banks have already at least started the process of divesting their wealth management businesses.

We remain optimistic on the outlook for our banking stocks to provide an attractive dividend yield for the BKI portfolio for some time yet.

It seemed inevitable that some sort of enquiry would happen. In fact, the Big 4 banks wrote to the Treasurer requesting an enquiry of some type in late November. UBS Research summed up the general feeling by noting that:

"The Banks have served Australia well for many years and have a reasonably high level of customer satisfaction. However, there is a disliking for banking institutions in the community and a perception that they are over-earning."

We will continue to watch the developments closely in the coming months and determine whether our assessment of the investment case of each of the banks held by BKI has altered.

The Telecommunications Sector

Telecommunications was the worst performing sector in the Australian equities market in 2017 as the fallout from the impact of the National Broadband Network (NBN) hit industry earnings in a more meaningful way. There has been a lot of NBN bashing in 2017, and much of it seems justified. The multi-technology mix is creating a lot of headaches, poor customer experience and delays.

The BKI portfolio has a position in both Telstra and TPG Telecom. The two investments have generated attractive returns and dividend income for many years. In fact, despite being in the same sector, the two telco companies have complemented each other in the BKI portfolio as we held one for yield and the other for growth.

2017 was an unhappy year for the telco industry, and with it, telco shares. We were negatively surprised by the extent of the cut in the Telstra dividend in August. However, the sustainability of the dividend going forward means that we are now treating the stock like an attractively yielding bond.

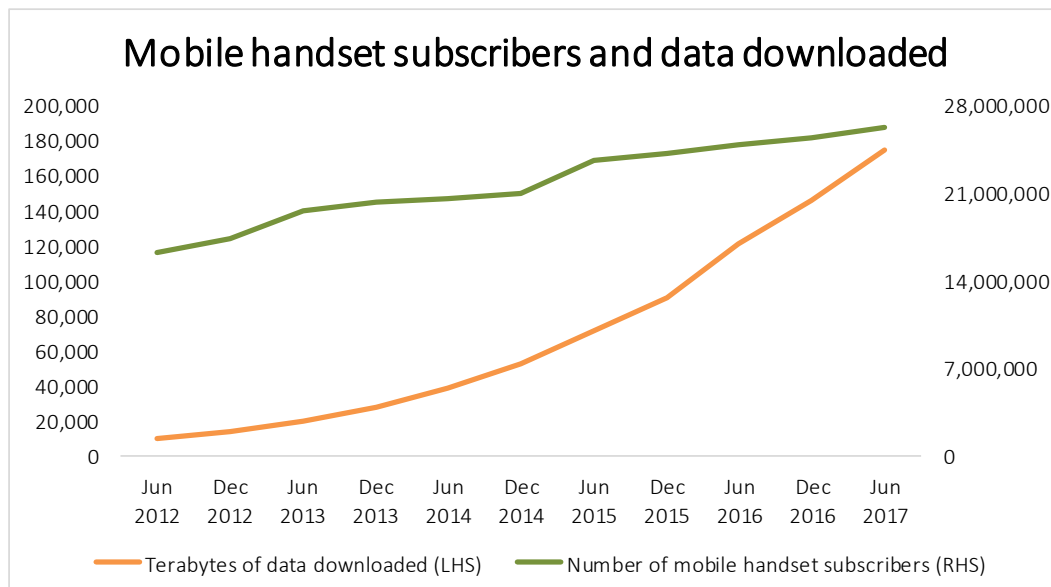
The TPG share price has been volatile over the past twelve to eighteen months. However we believe that the company is investing for growth and we back the longer-term mobile strategy. While near term earnings for TPG are likely to be lower than we are used to, the growth profile beyond 2020 looks compelling. We believe that, in a 5G mobile world, TPG will more than win back the customers that it loses to the NBN. TPG has a significant advantage against many other telecommunications peers due to the massive backhaul infrastructure it owns which will be used to carry the mobile data.

There are big expectations for 5G (or 5th generation mobile networks), which is expected to be introduced in 2020. According to a Wired Magazine article:

5G will be crazy fast, crazy stable, and crazy versatile. 10Gbps speeds won't be unheard of. It'll replace home Wi-Fi networks in many cases, offering faster speeds and better coverage.

"Basically, 5G will provide a wider pipeline and faster lanes," says Verizon spokesman Marc Tracey. By faster, think about speeds that are ten times faster than 4G LTE; you'll be able to download Lord of the Rings in seconds, and enjoy a live VR experience streamed to your headset from across the country with very little lag. 5G will also offer lower latency in network communications—picture a transit corridor filled with autonomous cars and drones reacting to wireless signals instantly in life-or-death situations.

Mobile data is a massive growth story and one that BKI is well positioned to benefit from through the investment in TPG Telecom and Telstra. The following chart, which is based on ABS data, highlights the rate of growth of data being downloaded. We believe that this exponential growth will continue for a number of years. The widespread acceptance of 5G technology will be a critical driver of this. We believe that fixed to mobile substitution will accelerate.



Our approach to managing the BKI Portfolio

As we look into next year, we note that widespread value is hard to find in the Australian equities market. As mentioned above, Australia has many attractive tailwinds and earnings growth has been strong. There are certainly reasons for optimism, yet we don't blindly chase high growth stories that are on ridiculous multiples. We are happy to be patient for opportunities – we continue to focus on the long-term. As Thomas Phelps wrote in his book, *"100 to 1 in the Stock Market"*, to make money in stocks you must have "the vision to see them, the courage to buy them and the patience to hold them." Patience is the rarest of the three, but it pays off in the end.

When we meet with Investors and Shareholders, we often discuss what we consider to be BKI's overall strategy. We believe that shareholders invest in BKI for an exposure to an Australian Equities portfolio, not for us to manage their overall cash position. Therefore, we will never hide in 20%+ cash, particularly when the incentive to do so is low from a Term Deposit rate perspective. At the end of November, BKI's cash weighting was approximately 5%.

As it stands, most Self-Managed Superannuation Funds already have a healthy exposure to cash. Australian Tax Office data shows that SMSFs had an average weighting of 22.5% in cash and term deposits at 30 September 2017. With Australian interest rates likely to remain unchanged for much of 2018, we believe there is the potential for some of this cash to be invested in good quality businesses with attractive growth prospects and who pay a solid and sustainable dividend.

We believe that the BKI Portfolio is well diversified going into 2018. We own approximately fifty companies in the portfolio with a range of sector exposures. We will continue our focus on buying high quality businesses to hold. Our goal is to maintain a portfolio that is durable enough to withstand most market risks and provides to shareholders progressively growing fully franked dividends with continued capital growth. BKI's fully franked dividend yield as at 30 November 2017 was 6.3% and Total Shareholder Returns, including franking credits, has been 11.7% per annum over the past thirteen years.

Thank you for your continued support in 2017 and we wish you all the best for the year ahead.

Will Culbert and Tom Millner

Contact Asset Management Pty Ltd.

Contact is the Investment Manager for BKI Investment Company Ltd. Will and Tom are both shareholders in BKI.

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