

MARCH 2018

BKI INVESTMENT COMPANY

ABN: 89 615 320 262



QUARTERLY REPORT

Leave Our Franking Credits Alone!

We have experienced an eventful start to 2018. The Australian reporting season has come and gone, the Royal Commission into the Australian banking system has commenced, we have seen the arrival of inflation in the United States, market volatility and computerised program-selling, concerns of a global trade war and a sell down in the technology giants. However, in this Quarterly Report we are going to focus on another event that has occurred. One we consider far more important and a bigger issue than any of the events discussed above; franking credits and the proposed cancelation of cash refunds on individual's dividends.



*BKI is managed by Contact Asset Management
AFSL 494045*

Welcome to the 18th issue of the BKI Quarterly Report, prepared by Contact Asset Management. These reports provide us with an opportunity to communicate with shareholders on high-level topics of interest. The reports are available on the website at www.bkilimited.com.au. We also encourage you to subscribe to the BKI mailing list.

An Eventful Start to the Year

It has certainly been an excitement packed start to the year with the Australian reporting season just gone, the commencement of the Royal Commission into the Australian banking system, the confirmed arrival of inflation in the United States, market volatility and computerised program-selling, concerns of a global trade war and a sell down in the technology giants.

Traditionally, we are happy with stable markets, with low volatility. However, when you get moments like this it can prove to be an unbelievable opportunity to invest.

After the recent Australian reporting season, our confidence in trends such as infrastructure, a growing and aging population and urbanisation have increased further. We saw positive momentum within the healthcare industry from the aging and growing population of Australia. We saw that further increases in infrastructure spend both here and offshore has assisted real estate, construction and industrial stocks, who are also expected to continue to benefit from positive domestic economic conditions. In addition, we saw many consumer discretionary and telecommunications stocks continue to work through industry challenges, proving that they may well be better businesses now than they were 6 to 12 months ago.

Broadly speaking, this reporting season ended with stronger than expected results and company guidance that reflected buoyant market conditions. Capital management initiatives were also front of mind, with many management teams finally having the confidence to focus on investing for the future. Announcements through share buybacks, acquisitions and general business investment were driven by stronger balance sheets, strong cash flows and improved operational certainty. For long term investors this is certainly a welcome change from achieving earnings growth simply through a significant cost out program.

The commencement of the Royal Commission into the Australian banking system began in February and is expected to run for 12 months. Hearings to date have been broad, focusing on vehicle finance, mortgages, insurance, credit cards and banking administration. After a month, no bank has been missed in receiving their fair share of allegations of failure, misconduct and oversight. It seems to be all leading to where we thought it would, even tighter regulations and a higher cost of doing business for the banks. We are confident the banks will come out of this ok,

maintaining dividends into the future and delivering long term earnings growth to their shareholders.

Following on from December, the Federal Reserve lifted US interest rates again in March and has forecast at least two more hikes by the end of the year. This has been in line with our expectations and underpins the stronger economic conditions and outlook of the United States. Our only concern is that the Fed moves too quickly, spurred on by increasing evidence of strong employment data pointing to wage inflation.

News of US economic growth and inflation sparked above average "Market volatility", a term that has been used almost daily by market commentators during the first quarter of 2018. This was further exaggerated through a lack of liquidity and seemed to be triggered in part by short term investors, driving markets higher one day, then lower the next. The focus of this volatility then turned to computerised program selling, with a typical trading day now seeing computers account for over 50% of market trade in the US.

We see this volatility and uncertainty continuing in the US. Professional fund managers and investors are stepping in causing a market correction based on stretched valuations, lacklustre outlooks and a few nerves, not just a computerised buy/sell program. It has gained further momentum on a number of fronts, including, concerns of a global trade war between the Chinese and the US, a sell down in the technology giants, after Facebook's use of personal data from its client base was revealed, Tesla's ongoing manufacturing issues and President Trump attacking Amazon claiming they are taking advantage of the US Postal Service, and suggesting that Amazon does not pay its fair share of tax.

There certainly has been a lot going on in domestic and global markets, but despite all the concerns and issues in the marketplace, we are going to focus on another event in this report, another issue that occurred during the quarter. It's one we consider far more important and a bigger issue than any of the events discussed above... The proposed attack on our franking credits.

The issue started with the opposition leader, Bill Shorten, announcing on March 12, 2018 that if Labor were to be voted in to government at the next federal election, they would introduce a policy that would effectively cancel cash refunds to individuals who own shares and claim tax credits on their dividends.

It's important to note that this proposed policy will affect all listed companies who pay dividends to shareholders, not just LIC's. Our dividend imputation system and franking credits have come under attack from the very government that introduced them in the first place.

The shift in franking credit use has been labelled by many as a “hit the rich policy”. However, this has been aimed (intentionally or not) at the low-income earners, mainly self-managed funds (SMSFs) and pensioners. It is these individuals who rely on the refundable franking credit as an enhancement to their annual income. These individuals don’t earn any more income, they’re retired and, in many cases, use these franking credits and cash refunds to live on.

Media reports have suggested that the policy was based on assumptions that it would hit about 8% of taxpayers. The piece that was missed, due to terrible advice, was that the data used was from financial year 2014/15. That 8% now represents around 1.17 million individuals and superannuation funds, including approximately 200,000 self-managed super funds. We think it’s important to point out to certain policy makers that these 1.17 million individuals vote.

The good news is that there has been a partial backflip from Labor on this proposed policy. Someone has begun counting votes and the actual impact this proposal has had on SMSF’s and pensioners. Someone within this party has discovered how stupid their initial policy was and has reacted to the public backlash against it.

As we understand it, pensioners will now be exempt from the policy and SMSF’s (with at least one member being in pension phase within that fund) will be Grandfathered (Grandfathering means investment decisions taken before a certain date remain subject to the old rules).

While there has been a partial backflip from this proposed policy, there is still a long way to go.

In our view the Australian imputation system needs to be protected and left alone. The franking credits that millions of Australians receive each year for investing in good quality Australian companies needs to be left alone. Retirees receiving cash refunds should not have their payments reduced, no matter how wealthy they are.

We believe we already have a system in place that is simple, and everyone knows where they stand. This system has been in place for many years and investors know what they can receive from investing in good quality dividend paying stocks.

We believe creating complexity and an unfair focus on our low-income earners and pensioners is wrong.

We believe raising additional budget revenue through the cancellation of franking credit refunds is wrong.

In this edition, we are going to spend some time on explaining what franking credits are, how BKI passes them on to shareholders and what they are worth to the

shareholder. This is a very important topic, one that may affect BKI shareholders and the millions of individuals that have investments in dividend paying companies listed on the Australian Stock Exchange.

“Under Labor’s plan,
anyone in retirement
and living on their
superannuation
savings will now have
every dollar of their
income from dividends
taxed at a rate of at
least 30 per cent.”

The Self-Managed Independent
Superannuation Funds Association, MD,
Mr Michael Lorimer

The History of Franking Credits

When looking at the issues surrounding the impacts on our dividend imputation system and franking credits, its important to revisit the history of them and how they came about.

Dividends paid to shareholders by Australian resident companies are taxed under a system known as imputation. Dividend Imputation, or what we like to call Franking Credits, was first introduced by the Labor Government in 1987. Bob Hawke was Prime Minister and Paul Keating was Treasurer. It was designed to avoid “double taxation” of company profits. Prior to franking credits, a company would pay tax on its profits, at a company tax rate of 30%, and then its after-tax distribution to the shareholders, or dividends, would be further taxed at the shareholder’s marginal rate. This could have been as high at 47% if an individual was on the highest tax rate.

Under the Coalition Government in 2000, Prime Minister John Howard and Treasurer Peter Costello introduced Franking Credits to be refundable. This was the beginning of cash refunds for excess franking credits. Until the year 2000, the ATO would keep all surplus franking credits.

Where Do BKI's Franking Credits Come From?

Below is a step by step explanation of where BKI's revenues come from and how we pass through franking credits to our shareholders.

- **Revenues** - BKI's revenues come from dividends, distributions and interest from cash. Based on BKI's dividend distributions for FY2017, 86% of BKI's revenues are fully franked dividends, which simply means that the dividends received by BKI have already had the 30% tax rate paid by the companies in which it invests; companies such as CBA, NAB, WBC, ANZ, WES, TLS, AGL, TPG, WOW, NHC.
- **Operating Expenses** - From the revenue received, BKI pays its expenses; e.g. Management Fees, ASX Fees, Registry Fees and Directors Fees. All kept to a minimum, contributing to a very low MER.
- **Income Tax Expense** - After BKI pays expenses it then pays tax. This is minimal due to the passing on of Franking Credits from the companies in which it invests. BKI effectively only pays tax on interest received from cash plus any unfranked dividends and trust distributions, less all expenses paid.
- **Net Operating Result** - These are the profits BKI makes from dividends and distributions from investments and interest from cash, less taxes and expenses paid for running the company.
- **Earnings per Share** - The portion of BKI's Net Operating Result divided by the weighted number of shares on issue.
- **Dividends per Share** - Due to the passing on of franking credits and very low expenses, BKI can pay out dividends to its shareholders from almost all revenues received from its investments.

BKI's Tax Efficiency and Tax Rate

BKI can provide shareholders with tax effective capital management. Dividends are fully franked with tax credits passed on to shareholders.

Based on FY2017 dividend distributions, 86% of BKI's revenues come from fully franked dividends, meaning that the dividends received by BKI have already had the 30% tax rate paid by the companies in which it invests.

As well as the payment of Ordinary Dividends, BKI can pay out Special Dividends, which can also have franking credits attached. BKI has paid out Special Dividends to shareholders in the form of 5 Fully Franked Special Dividends since listing in 2003.

BKI has a positive franking credit balance, which should ensure any future dividends would be fully franked.

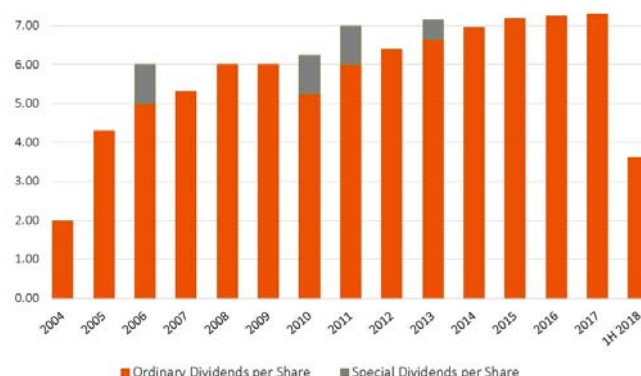
Being a Listed Investment Company, BKI can also pass on benefits to shareholders in the form of a LIC Capital Gain. If a capital gain was made by BKI from selling an investment held for more than 12 months this benefit may be passed back to certain shareholders as part of a fully franked dividend.

BKI's Dividend History

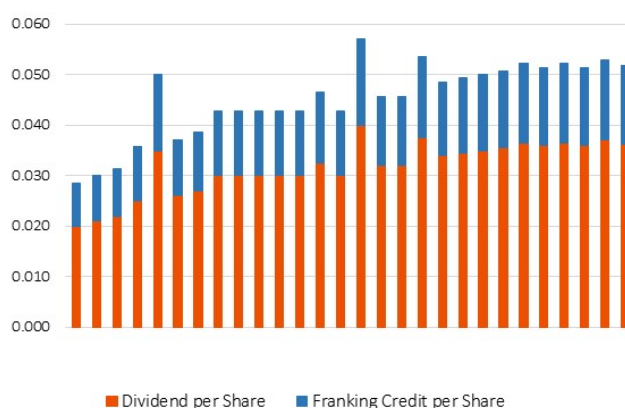
BKI's Board & Portfolio Managers have always been large shareholders in BKI. We invest for the long term and focus on creating wealth for all shareholders by keeping costs low and increasing fully franked dividends and capital growth.

As at 31 March 2018, BKI's fully franked dividend yield was 4.6% (includes the FY2017 Final Dividend of 3.70cps and the FY2018 Interim Dividend of 3.625cps and is based on a share price of \$1.58), while the grossed-up yield was 6.6% (Grossed up yield is based on a tax rate of 30%).

The orange bars in the chart below shows full year dividends paid out by BKI since listing in 2003, while the grey bars show Special Dividends. The 2018 dividend shows the first half only. BKI expects to declare the final dividend for 2018 with full year results on 18 July 2018.



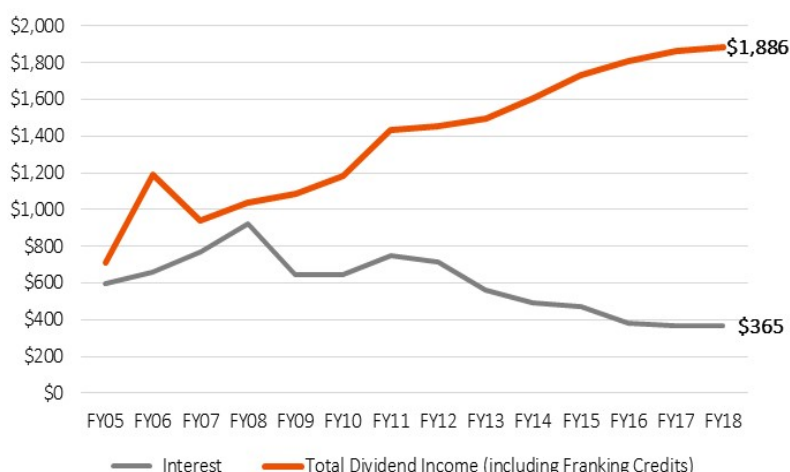
BKI listed on the 12th December 2003 at \$1.00 per share. As at 31 March 2018, and as shown in the chart below, the total dividend payments including franking credits made by BKI to shareholders since listing totalled \$1.268 per share. This equates to over \$500 million in dividend distributions and franking credits to shareholders. Franking Credits paid out are based on a tax rate of 30%.



Income Generation Through Long Term Investing

The following scenario highlights the opportunity of shareholders receiving a fully franked dividend over a long period of time, especially in a low or falling interest rate environment. In this situation, we aim at showing what dividends and franking credits could be received from a \$10,000 investment in BKI at inception versus bank quarterly interest.

In the consideration used below, an investor who spent the equivalent of \$10,000 to purchase BKI shares upon listing in December 2003 would now be receiving fully franked dividends of \$1,320pa. The franking credits enhance the income by a further \$566, assuming a tax rate of 30% (total income of \$1,886).



The same investment in a term deposit (based on the cash rate + 0.50%) would be earning \$365pa with no franking credits, and tax payable on interest earned.

Franking Credits, what are they Actually Worth?

As we've discussed and made very clear, dividends and franking credits have the potential to increase after-tax returns to Australian Shareholders in all investment phases; pension, SMSF or accumulation phase.

The table below assumes a \$10,000 investment in BKI shares at \$1.58 (a holding of 6,329 BKI shares). Dividend income is calculated using rolling 12-month dividends of 7.325 cents per share (includes the FY2017 Final Dividend of 3.70cps and the FY2018 Interim Dividend of 3.625cps).

	A	B	C	D
Shareholders Marginal Tax Rate	0%	15%	30%	47%
Dividend Income	\$463.60	\$463.60	\$463.60	\$463.60
Franking Credits	\$198.69	\$198.69	\$198.69	\$198.69
Taxable Income	\$662.28	\$662.28	\$662.28	\$662.28
Grossed Up Dividend Yield	6.62%	6.62%	6.62%	6.62%

As the table demonstrates, shareholders at any tax rate can benefit from franking credits attached to BKI dividends. For example, Shareholder A (an investor in pension phase who pays 0% tax) will receive all franking credits as a tax refund. This equates to a Post Tax Dividend Yield of 6.62% or \$662.28 in after tax income.

Gross Tax Payable	\$0.00	\$99.34	\$198.69	\$311.27
Less: Franking Credits	-\$198.69	-\$198.69	-\$198.69	-\$198.69
Tax Payable / (Refundable)	-\$198.69	-\$99.34	\$0.00	\$112.59
After Tax Income	\$662.28	\$562.94	\$463.60	\$351.01
Post Tax Dividend Yield	6.62%	5.63%	4.64%	3.51%

This is the exact cash refund that the Labor party is trying to abolish. It's believed that it affects around 1.17 million individuals and superannuation funds, including 200,000 self-managed super funds... No wonder we've seen a backflip on this policy.

Interest Income on a \$10k Term Deposit @ 2.00%pa	\$200.00	\$200.00	\$200.00	\$200.00
Tax Payable	\$0.00	\$30.00	\$60.00	\$94.00
After Tax Income	\$200.00	\$170.00	\$140.00	\$106.00
Post Tax Yield on Term Deposit	2.00%	1.70%	1.40%	1.06%

To highlight further how valuable these franking credits can be, if the same \$10,000 was invested by Shareholder A in a Term Deposit with a rate of 2.00%pa, after tax income would be 70% lower at \$200.00. If you're a low-income earner, have a self-managed fund (SMSFs) or are in pension phase, this reduction in income can be very significant and impact your living standards significantly.

Cash Benefit of Fully Franked Dividend	\$462.28	\$392.94	\$323.60	\$245.01
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Leave Our Franking Credits Alone!

Most SMSF's have a healthy exposure to cash. Australian Tax Office data shows that SMSF's had an average weighting of 22.5% in cash and term deposits at 30 September 2017.

We believe that Australian interest rates are likely to remain unchanged for much of 2018, so there is real potential for some of this cash to be invested in good quality businesses to help enhance an individual's income. The income will come from companies who pay a solid and sustainable dividend with franking credits attached.

Investors need to have confidence that policy makers don't keep changing the goal posts.

The BKI Portfolio is well diversified with approximately fifty companies in the portfolio, offering a range of sector exposures and a sound income. We rely on dividends and franking credits that these companies distribute, so we can pass them both on to our shareholders.

Our goal is to maintain a portfolio that is durable, withstands most market risks, and provides to shareholders progressively growing fully franked dividends with continued capital growth.

We will continue our focus on buying these high-quality businesses to hold for the long term, and we will continue to fight for the Australian imputation system to be left alone so that the franking credits and cash returns that millions of Australians receive each year for investing in good quality Australian companies continues. It needs to be protected so that retirees receiving cash refunds should not have their livelihoods impacted.

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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