



The Leading Edge

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In this edition of *The Leading Edge* we look at how companies are restructuring and deploying technology to protect profits in a low-growth environment.

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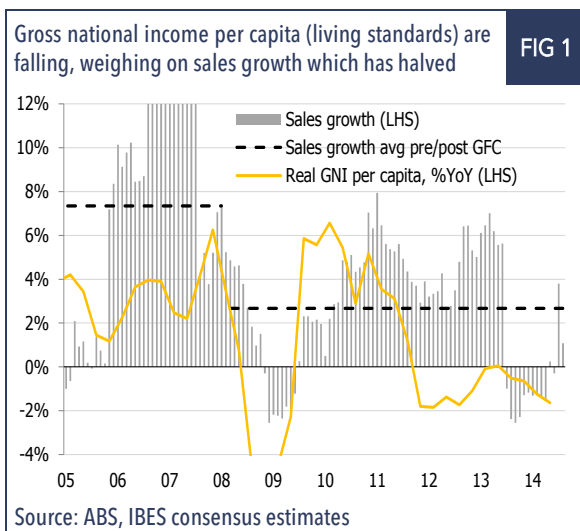


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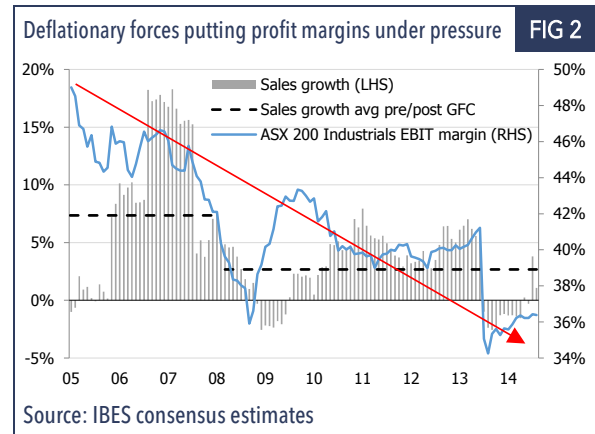
Making Australian Industry competitive again: Restructuring and technology are key value drivers in a low-growth environment

In previous editions of *The Leading Edge* we have outlined the reasons why we believe economic growth will be softer in the medium term and how Australia faces further challenges with the end of the mining boom. As commodity prices continue to fall across the board, a deeper downturn in mining now appears likely. A second round of income shocks can be expected as revenues fall. This is occurring at a time when business investment is contracting sharply as key mining projects reach completion.

Reflecting these trends, you can see in **Fig 1** how income growth has slowed markedly in Australia. On a per capita basis, income has been falling in recent years and with discretionary costs squeezing household budgets, living standards have also fallen. This is translating into weaker revenue growth for public companies, which is now just half the level considered normal a decade ago.



Following 25 years of uninterrupted growth Australia is an expensive place to do business. Many Australian companies are struggling to remain competitive, this is manifesting in lower profit margins than before the financial crisis (**Fig 2**).



This is the backdrop for many companies; softer trading activity and margin pressures. Gone are the days when companies operating in protected, highly concentrated industries could simply put prices up year after year. The weakness in the Australian dollar is pushing up input costs, further squeezing margins as companies are unable to fully recover these increases through higher prices.

The commercial landscape is challenged further by the disruptive impact of technology on traditional client/customer relationships. This is a difficult setting for public companies: dealing with anaemic growth; cost pressures; and discerning customers looking for better value.

At Watermark we meet regularly with Australian companies. There are two consistent messages coming through in these meetings as these companies adjust to weaker trading conditions. First of all with top line and margin pressures increasing, there is a renewed focus on costs. Restructuring is a hallmark of many company presentations. Some of the best investment opportunities will be found in those companies with the most scope to reduce costs. Secondly, companies are rapidly embracing technology, not just to improve productivity but to enhance sales execution as well. In this edition of *The Leading Edge* we look at how companies are restructuring and deploying technology to protect profits in a low growth environment.

Market Outlook

The Australian share market is in trouble. Shares are fully valued and earnings growth is decelerating. At the same time the tailwind from lower interest rates is fading; while short-term rates may move lower, longer-dated bond yields have probably bottomed.

The resources sector is in a bear market which will continue for years to come; while we will see sharp rallies from time

to time, these will be short-lived as the structural downtrend continues. Through time, commodity prices have tended to trade around cost support. While a number of commodities have already fallen back to these levels, as yet this has not played out in the share market, so in the medium term we would expect mining shares to move lower.

The Australian banks still have to raise more capital and this is dilutive for earnings. The credit cycle also appears to be turning, and with reserve releases abating non-performing loans will once again put pressure on profits. Banks target positive "jaws" where revenues grow faster than costs. In the most recent results however costs have been growing faster than revenues and profit growth has stalled.

While the Australian share market can best be described as mature with few growth sectors, the most important of these sectors - healthcare - is struggling with downgrades from almost all the major names as fiscal tightening bites and emerging market growth slows.

The re-rate of yield sectors in the market is also largely complete as interest rates are unlikely to fall much further.

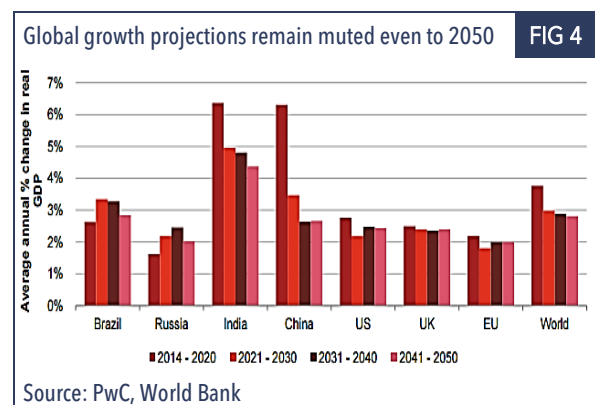
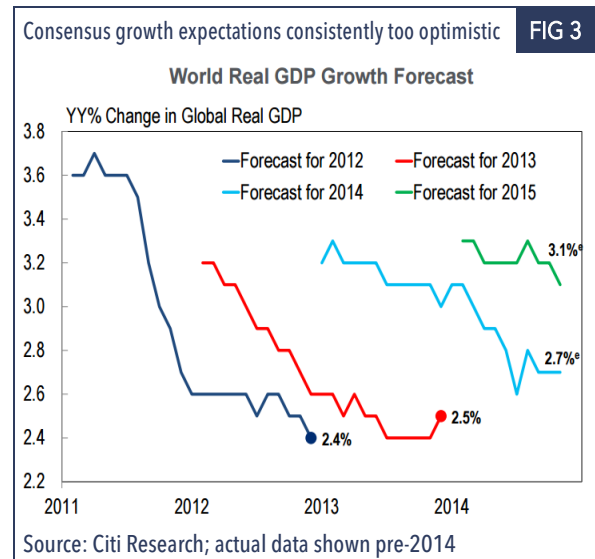
Pervasive deflationary trends globally, a function of surplus capacity and sluggish demand, is the underlying cause of low interest rates and commodity prices. Investors have bid up shares as an alternate source of income while rates have fallen, in the belief that shares are more valuable in a low interest rate environment. The reality is quite different: since low rates are a reflection of weak demand, profit growth is likely to be much weaker in years ahead. We are seeing this already playing out in many sectors where prices are falling, volumes are weak and margins are under pressure.

In this deflationary environment, profit growth will be muted. With valuations full by historic standards, we believe shares will offer low returns at best in the medium term. If this proves correct then we are well positioned, as active management strategies like long/short investing can create significant value through security selection without the risks of being exposed to the share market. We would expect to deliver attractive returns for our investors in the medium term irrespective of the direction the market takes.

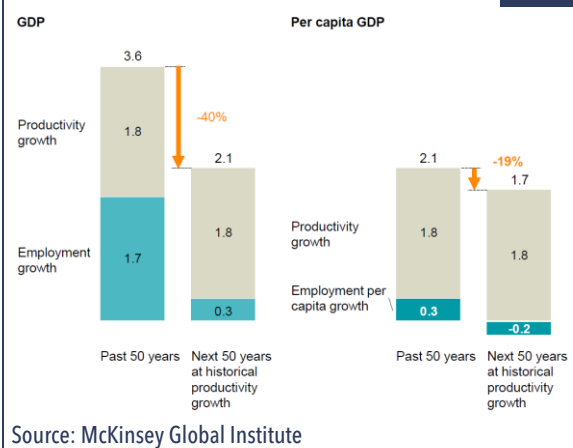
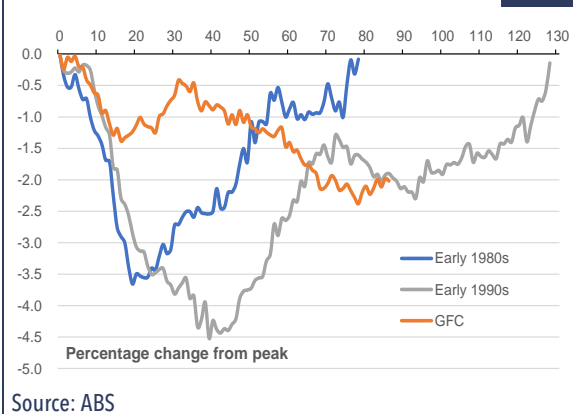
Where will the growth come from?

The outlook for the global economy appears bleak (Figs 3 & 4). Many economies still find themselves in a low growth environment as the post-GFC recovery proves to be more long-dated than following previous downturns. Perhaps more worryingly, a significant demographic shift in the form of an ageing global population - underpinned by lower birth rates and higher life expectancy - raises uncertainty

around the long-term growth outlook. It is becoming increasingly clear that the rapid growth seen over the past 50 years, during which global GDP expanded sixfold and average per-capita income has tripled, is unsustainable.



Basic economic theory dictates that growth is a function of labour, capital and productivity. As covered in the last issue of *The Leading Edge*, in this low growth/low interest rate environment companies are being pressured by shareholders to invest less and increase their payouts to shareholders in the form of dividends and share buybacks. Given the aforementioned structural decline in global labour markets, it is likely that future growth will need to be driven by increases in productivity. A report by the McKinsey Global Institute estimates that global GDP growth over the next 50 years will be 40% lower than the previous 50 as a result of a weakening labour market (Fig 5). This decline must be offset by productivity growth that is 80% higher than it has been historically, if growth in living standards is to be maintained.

G19 and Nigeria, CAGR in nominal GDP
FIG 5

Employment/population ratio post recessions (months)
FIG 6


While Australia has been the beneficiary of a mining boom that allowed it to weather the GFC without dipping into recession, a weaker labour market is symptomatic of the low growth environment that we now find ourselves in (Fig 6). The productivity gains required to drive companies' profitability may however be realised in other ways; namely: adoption of existing best practices - essentially cost-out - which McKinsey estimates will account for $\frac{3}{4}$ of the growth, and innovation or technological advances that will increase the economy's overall productive capacity.

Many companies have recently begun to speak publicly about opportunities to drive efficiency through technological change. We broadly categorise these into three opportunities available for Australian companies: data analytics; communication and collaboration; and cost-out through automation.

Data analytics

Data is often touted as the 21st century's most valuable commodity. The sheer volume of data currently being processed - with estimates that over 90% of all data in the

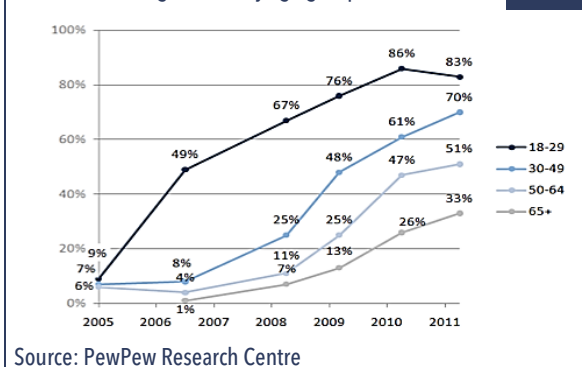
world has been created in the last five years - has made it possible to capture information in ways never before feasible. Data has become another raw input into doing business, and companies will need to adapt in order to better manage this new resource.

One significant advantage that presents itself is better business intelligence. Companies are collecting more data than ever before which they can process to paint a more complete picture of their operations. They can do this in a number of ways:

- Data from R&D, engineering and manufacturing departments can be integrated in order to cut time to market and improve quality.
- The rise in digitisation of transactional data will enable companies to form more accurate and detailed analyses of drivers and variability of performance.
- Detailed customer data allows for segmentations of the population, which will assist both to forecast industry trends and to develop tailored products and services.
- Facilitating interaction with customers, for instance being able to monitor order status from production to shipping.

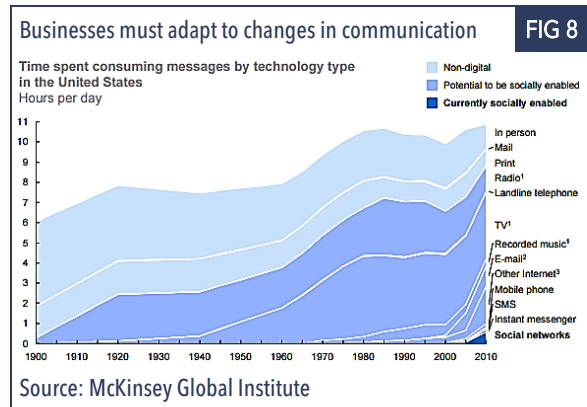
Communication and collaboration

It is remarkable how drastically humans have altered the ways in which we interact with each other over time. Fig 7 shows how in just five years, social networking has become a staple component of our lives; far outpacing the speed with which telegrams, telephones and emails became widely adopted forms of communication.

Social networking site use by age group, 2005-2011
FIG 7


As discussed, the speed and ease with which information can now travel requires the adoption of equally fast-paced business practices in order to maintain relevance (Fig 8). A good example is the many businesses now offering live chat sales and support, giving consumers an immediate point of contact rather than waiting on hold for a call centre. We are

also becoming an increasingly mobile-centric society, with more businesses developing applications to take advantage of this new medium and the wealth of data (e.g. location and contacts) it offers. Social data can be invaluable given the personal insight it offers into consumer preferences, which can assist businesses in demand forecasting (based on social trends), market research, lead generation and even sales (e-commerce).

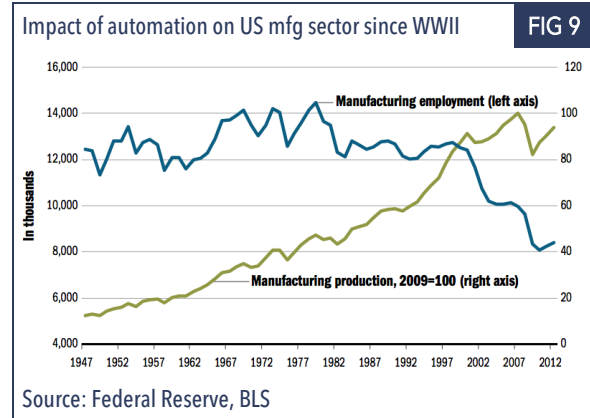


On an internal level, an increasingly prevalent trend of outsourcing and reduction in headcount as a result of cost-cutting since the GFC has dispersed skills and experience within companies beyond the reach of face-to-face communications. Video-conferenced meetings and internal messaging applications have become commonplace among most large organisations. The disruptive 'cloud computing' model allows companies to leverage offsite infrastructure for storing, managing and processing their data, which has made the transition even simpler.

While this movement is still in its infancy, there has also been a rise in the popularity of online freelancing websites. These are large marketplaces for labour where users can bid on jobs posted by companies in reverse-auction style, with companies able to select potential workers based on a community rating system. In a more globalised world where outsourcing has become the norm and most companies in developed economies such as Australia have limited access to ever-larger pools of talent in emerging markets (as opposed to the more highly-unionised and relatively inflexible domestic workforce), use of such services may become more widespread as companies place higher value on labour flexibility.

Cost-out through automation

From the dawn of the Industrial Revolution, automation has undoubtedly been the primary driver of productivity growth, particularly in capital-intensive sectors such as manufacturing.



Electronic systems and digital technologies have helped to further automate production lines, while ensuring more consistent quality in the absence of human error. We are now moving into an era of 'white collar automation' and robotics, with self-driving cars and artificial intelligence computing now closer to reality than science fiction.

We identify a number of opportunities for Australian companies to reduce costs through technological adoption:

- **Eliminate manual data processing:** Humans are innately limited in our ability to consume and understand information. Automated computer programs are better suited for analysing large and sophisticated data sets while potentially improving decision making, minimising risks and unearthing valuable insights that would otherwise have gone undetected by a human. **Example:** insurance agencies are now able to use automated risk engines that analyse customer data in order to determine premiums.
- **Focus on integration and optimisation:** Many Australian companies, particularly those that have grown through time via acquisitions, are running either legacy IT systems or a mixture of incompatible systems that need to be managed concurrently and staff who need training in each different system. **Example:** the Australian banking sector, where significant capital has recently been invested in a complete overhaul of the banks' bloated legacy IT platforms, with the benefits of long-term cost savings and operational efficiencies.
- **Reduce labour intensity:** The ratio of employee expenses to sales for Australian companies is currently about 15% on average. For this reason it comes as no surprise that headcount reviews are almost always one of the first components of a cost-cutting drive. Consumers' increasing familiarisation with using technology presents the opportunity for businesses to

establish low-cost, online-only services backed by limited support staff which are more competitive and provide customers with greater control in terms of managing their own account. **Examples:** Many industries are being disrupted by this new business model, particularly as consumers are now more budget-conscious. This is particularly prevalent across telecoms (most MVNOs, which offer better value for money than the three large operators, operate with an online-only BYO device model), utilities (many emerging competitors such as Powershop are differentiating themselves in this way) and now even banking (with NAB's online-only brand uBank almost at half a million customers).

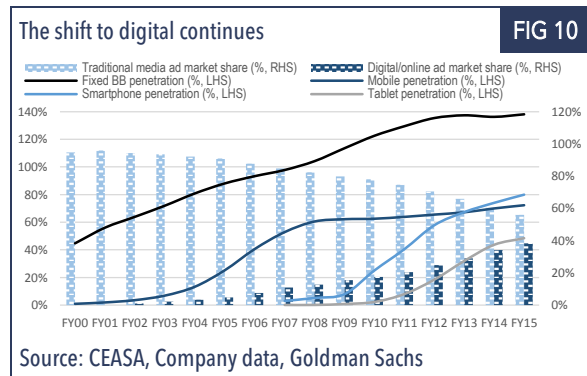
- **Robotics:** For more capital-intensive industries this will be the most disruptive technology. Robots can work around the clock, bear much greater physical loads and are more reliable than human workers; as is evident through the significant efficiencies seen in Asciano's port automation.

The flipside is that technological innovation has reduced the barrier to entry in many industries. Incumbents in resource-intensive businesses are seeing their well-entrenched position being threatened as high-margin processes are being commoditised. Jeff Bezos (CEO of Amazon) expressed this unambiguously: "Your margin is my opportunity".

As many Australian companies are scrambling to cut costs in an attempt to maintain margins in this low-growth environment, we identify a number of industries where technology is being used as a key driver for improving productivity; namely media, banking, insurance and utilities.

Case study 1: Australian media sector

The media landscape is constantly evolving. Advertisers follow eyeballs, spending budgets wherever consumers flock. However audiences are bifurcating as digital ingestion grows. Broadband and smartphone penetration continues to rise, permanently changing the distribution model for many media businesses.



Unfortunately, Australian companies are largely exposed to the decaying trends of traditional media. Print, TV and radio are being usurped by global distribution platforms. Google (and its subsidiary YouTube), Facebook (including Instagram), Twitter, Netflix and Spotify are all absorbing local audiences, demanding more ad dollars at the expense of local incumbents.

This technological disruption is weighing on local media companies and as a result they will need to turn to costs and technology to defend their profits.

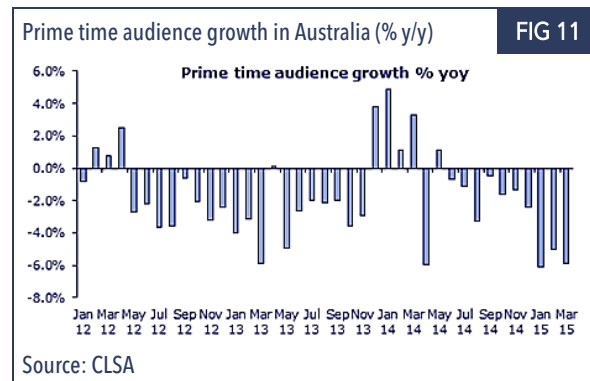
Newspapers

Newspapers globally have had their businesses disrupted as consumers enjoyed largely free news distributed online. Readership declines saw advertising and classified dollars disappear, forcing restructures and cost-out. Printing press closures, out-sourced sub-editing and paywall introductions have acted to arrest some of the decline in profits. For the most successful mastheads (Financial Times, New York Times and Wall Street Journal), circulation revenue (the cost of the paper or digital subscription) now far outweighs advertising revenue and profits are starting to rise. While this industry is deep into a digital conversion, other mediums have only just begun.

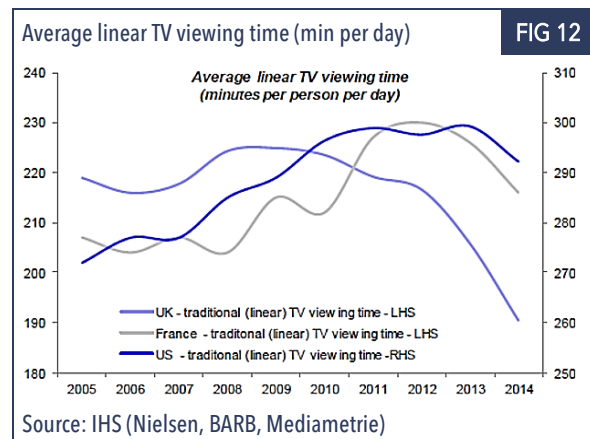
Free-To-Air (FTA) Television

FTA TV has long been a staple of any advertising budget, enjoying roughly 30% of total ad spend. However the launch of Over-The-Top (OTT) services such as Netflix, Apple TV, YouTube, Amazon Instant Video and many more have

created vast alternatives to linear television. This has led to loss of audiences across all major networks.



Unsurprisingly these trends are occurring globally. Advertisers will continue to pull money from the category while audience levels decline.



Nine Entertainment and Seven West Media have both launched their own OTT services, Stan and Presto, in joint-ventures with Fairfax and Foxtel respectively. Considering the importance of scale in this business, it was disappointing to see two separate domestic services launched. Netflix has amassed over 60million subscribers globally, and is planning to invest \$6bn in content next year alone. Original content titles are up to 13 and they have a target of 75-80 within five years. This enables Netflix to take programming risks that the networks cannot. Whether the domestic providers will be successful is yet to be seen, either way they will have to rebase the cost structures in the networks.

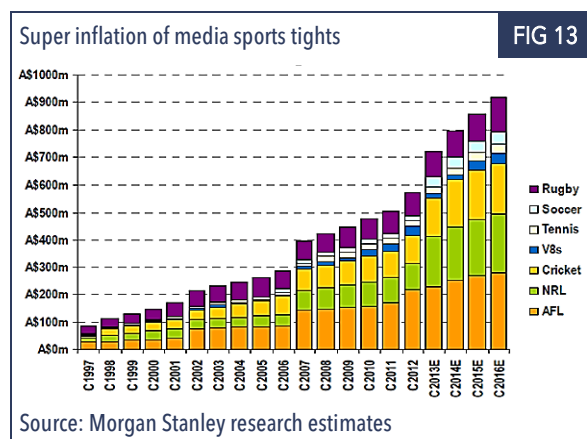
Programming expenses account for the vast majority of spend of the FTA networks. This can broadly be broken down into News, General Entertainment and Sport.

News continues to perform well as consumers demand a relevant nightly news service. While the networks are well placed to deliver this, savings must be found in this challenged environment. Seven West Media have recently

merged the newsrooms of The West Australian and Seven Perth. This integrated newsroom is a first for Australia despite being commonplace in Europe. While an eloquent solution exists in WA, ownership structures largely prevent similar outcomes on the East Coast. Where cross-media integration is difficult to achieve, technology is being used to reduce costs. Journalists are now equipped with handheld devices enabling video content to be shot and sent back for editing without the need for production crews.

General Entertainment is the segment most under-threat from OTT providers. Consumers prefer on-demand 'binging' of TV series, an offer unable to be delivered via linear TV. The US TV studios have long been a cornerstone of Australian programming, however their appeal has been lost. We estimate Nine Entertainment pays \$150-170m annually to Warner Bros for largely unsaleable inventory. This deal expires in 2016 and should deliver savings for the company, freeing up resources for reinvestment in local programming. As with networks globally, Australian companies are producing more content in-house. This ultimately needs to appeal to viewers, but does enable better cost control through production.

Sports are seen as a 'must-have' for TV networks. In a world where eyeballs are straying across mediums, live sport is still able to deliver the mass audiences that advertisers demand. The problem for the TV networks is the rampant inflation in the cost of sports rights at a time when revenue is declining. Added to this the challenge of new competitors, as digital rights attract the likes of Google and Netflix.



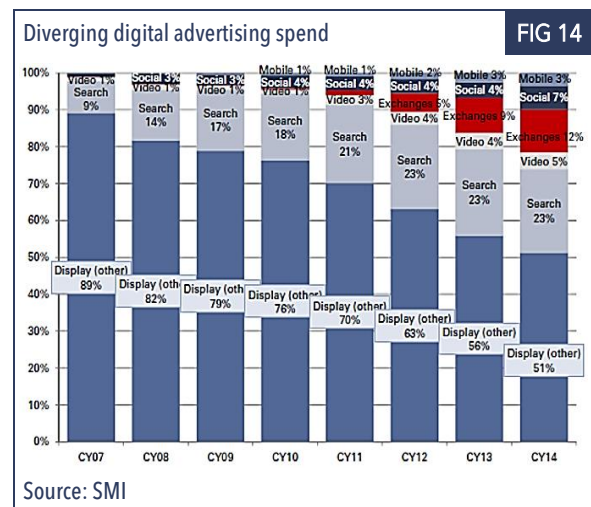
Radio

While radio to date has largely been immune from audience declines, the rapid uptake of streaming services from Spotify, Apple and Google signals alarm. Local radio companies have embraced technology, investing heavily in their streaming and digital businesses, providing listeners

with easy mobile and desktop options. Aware of the threats posed by global streaming services, local radio companies appear to have time to refine their business models. However, the user experience of ad-free, targeted playlist, social engagement and global on-demand inventory certainly appeals to listeners. Time will tell if Australian consumers switch off the radio.

Digital Businesses

Online media companies have carried this advertising tailwind for a number of years, however divergent trends exist even amongst online spend.

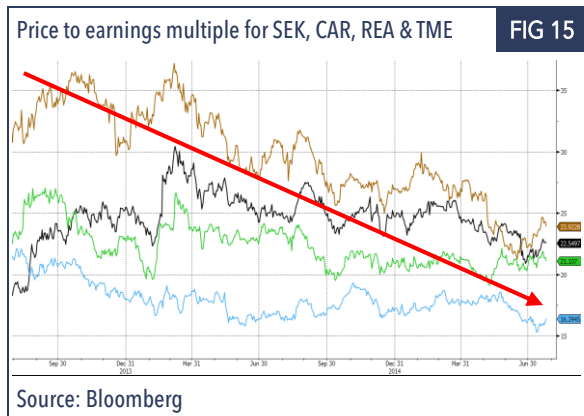


Digital display advertising, the first generation of online advertising continues to see deflation as endless inventory is auctioned off through 'ad exchanges'. Social Media and Mobile currently command just 10% of online ad spend, however this number is growing fast. A 'mobile first' strategy by large global media companies is a priority on mobile platforms as audiences spend more time on the go. Google reported at its recent June result that mobile YouTube usage grew 60% in the quarter. Advertisers will inevitably follow this proliferation of mobile usage. Further benefitting Social Media advertising is the inherent data capabilities of the medium. Advanced targeting, audience creation, SKU matching and carousel ads allow advertisers far superior methods through which they can monitor return on investment than the purchase of traditional 'spots and dots' from TV networks.

This wave of mobile penetration and diverging digital spend is impacting the highly successful online classifieds businesses. Seek, CarSales, Trade Me and REA have all benefitted from advertisers transitioning their online advertising spend. However, in anticipation of this trend

maturing, these companies are investing now, for future revenue opportunities outside their core classifieds model.

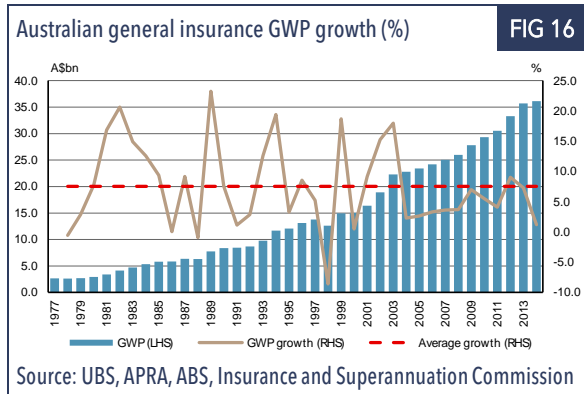
CarSales has purchased a finance broker; REA has purchased an online rental application business; and Seek is investing beyond pure job notices. While significant opportunities exist to leverage their dominant consumer positions, investors have thus far been unwilling to pay for these growth options with the companies de-rating over the last two years.



Case study 2: Australian insurance sector

Duopoly feeling the squeeze

A multi-year period of double-digit rate increases across motor and home insurance drove high single-digit premium growth across the Australian general insurance industry from 2010-2013. However, with rate increases moderating and a sluggish economy constraining volume growth, gross written premiums (GWP) are barely growing.



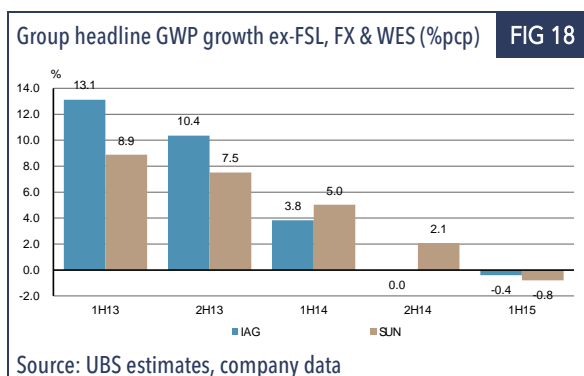
IAG and Suncorp have also been losing share in motor and home insurance to smaller, more aggressive competitors. These "Challengers" have increased their share of the motor market from 5.1% to 13.5% over the past four years, mainly at the expense of IAG and Suncorp.

Motor GWP and market share changes (CY10 - CY14) **FIG 17**

	CY10		CY14		4-year GWP CAGR (%)	Market share change (%)
	GWP (\$m)	Mkt shr (%)	GWP (\$m)	Mkt shr (%)		
SUN	2,372	35.7	2,552	32.1	1.8	-3.6
IAG	2,198	33.1	2,494	31.4	3.2	-1.7
Mid-tier	1,245	18.8	1,421	17.9	3.4	-0.9
Challengers	336	5.1	1,074	13.5	33.7	8.5
Other	490	7.4	402	5.1	-4.8	-2.3
Total	6,642	100.0	7,943	100.0	4.6	

Source: UBS estimates, company data, APRA

The combination of the above factors resulted in a GWP contraction for IAG and Suncorp in 1H15 (by 0.4% and 0.8% respectively) when only two years earlier GWP had been growing at close to 10%.



Cost reduction strategies

As top line growth has disappeared the focus has shifted to cost reduction, with Suncorp most advanced in its program. Despite the absence of M&A activity since their merger with Promina in 2007, Suncorp are now in their third phase of a comprehensive cost restructuring program. Given their relative weakness in systems and customer retention, Suncorp were forced to be the first mover in their cost out program and by 2018, Suncorp expect to achieve additional annual margin benefits of \$670m p.a. vs. the total one-off investment of \$540m. Despite this, insurance margins continue to decline as more recent cost out initiatives for Suncorp and their peers are being reinvested for customer retention with the primary lever being reduced rates.

IAG have undergone a different trajectory to Suncorp. After largely overlooking cost out as a lever prior to their acquisition of the Wesfarmers insurance arm, IAG are now focused on an integration and transformation push. Recognising the limited opportunities for top line growth, IAG are in their first year of a three year strategy to realise \$230m of annual margin benefits by FY17, with \$50m of reinsurance savings and \$180m from headcount reduction.

Technology

Technology will play a key role in converting Suncorp's cost initiatives. Better data analytics will generate cross sell, up sell and retention benefits. This has been gaining momentum over the last two to three years. As at 30 June 2015, Suncorp had ~90% of their data on "cloud" based systems creating a "data lake" which allows better claims servicing, business analytics and partnering with other data providers.

Despite its first mover advantage, Suncorp appears to have largely tapped out all of the easy wins from cross sell, up sell and retention across brands and is having to look towards more innovative ways to sell products. This remains a work in progress.

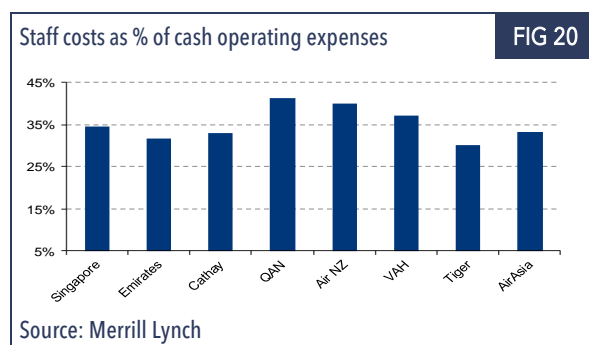
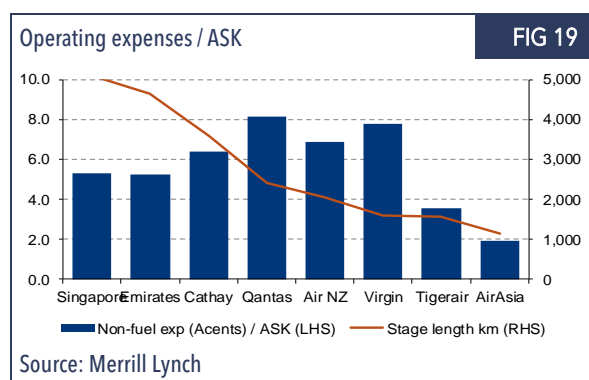
Following the Wesfarmers acquisition, IAG have also officially begun their push into digital innovation. In March 2015, the CEO of IAG Commercial (Peter Harmer) was placed on secondment for 6 months as Chief Digital Officer. After arranging exclusive Australian arrangements with LinkedIn, Salesforce and Xero, this exercise is expected to create new marketing platforms and opportunities for the company.

Case study 3: Qantas

Revenues under pressure

Qantas faces ongoing top line pressures in the form of a consistently diminishing market share on its international routes and a weak Australian economy. The Qantas group had a market share of 30% of international passengers to and from Australia in June 2004. By December 2014, this had fallen to 24%. The key driver of this decline has been international competitors (Emirates, Etihad, Cathay Pacific and Singapore Airlines) who have added capacity given lower unit costs (staff and maintenance expense). Regarding the weak Australian economy, Qantas said with its 1H15 results that the demand environment was 'mixed' with softness in leisure, resources and Government sectors, all of which are important markets for Qantas.

The disadvantage that Qantas faces on international routes in terms of its higher cost base can be seen in **Figs 19 & 20**.



Transformation Program

Qantas incurred a loss before tax in FY14 of \$646m, and after write-downs this equated to a net loss of \$2.8bn. In response, Qantas unveiled a three year transformation program with a target of realising \$2bn of gross benefits by FY17 and reducing debt by \$1bn by FY15.

Qantas hasn't traditionally been an early adopter of new technologies. Asian and Middle Eastern airlines have had

better balance sheets and more ready access to funds. This has put Qantas at a disadvantage in terms of yields given competing airlines have had younger, more attractive fleets which are also more fuel efficient. But Qantas is working on a couple of technology initiatives that, while not as meaningful as the cost out targets, are aimed at introducing efficiencies or opening new revenue streams.

Fleet simplification strategy

Qantas announced a fleet simplification strategy as part of its cost out program. The aim was to minimise maintenance costs and improve utilisation of the fleet via a more standardised approach.

Qantas will reduce its aircraft types from 11 to 7 by the end of FY16. This allowed for the closure of the Melbourne and Sydney maintenance facilities with labour reductions of about 500 staff and consolidating maintenance in Brisbane.

The simplification strategy and improved practices have meant that by the end of FY15, aircraft utilisation is expected to be up 16% on FY12 levels. This improved asset turn will make a meaningful contribution to improved earnings. At the same time, Qantas's average fleet age is now down to 7 years, which is the youngest since its privatisation in 1995.

Qantas Loyalty

Qantas's Frequent Flyer program has grown EBIT by a CAGR of 14% over the period from FY08 to FY14. It is a significant business line and generates c30% of group EBIT but loyalty member numbers are now at 10.7m versus Australia's total population of 23m which suggests the business is approaching maturity.

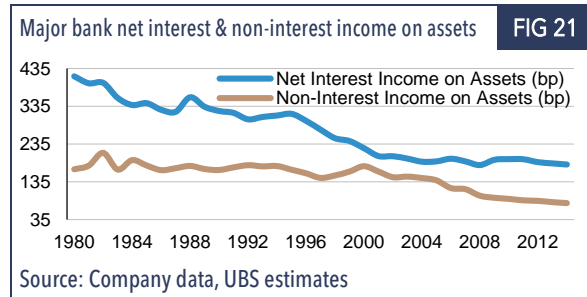
Qantas has recently acquired a data analytics company (Taylor Fry). The aim is to provide clients (banks, large retailers) with better data around purchases made when an individual uses a Qantas Frequent Flyer card. Qantas have also established Red Planet which will market customer products to Qantas Frequent Flyers. Qantas recently gave an example whereby Dymocks have seen a 30% lift in book sales by directly targeting Qantas Frequent Flyer customers via the program.

Booking system

From August 2015, Qantas will be introducing the PROS Revenue Management System to replace the current booking system. This will allow for better yield management via pricing across the full origin and destination of trips, rather than just a flight-by-flight basis. Qantas hasn't provided a revenue benefit forecast for the new system, but it puts the airline in-line with best practices.

Case study 4: Australian banks

Revenue headwinds for major banks over the last 5 years have been varied, a combination of: (1) subdued demand for credit in all areas other than investor housing delivering weaker interest earning asset growth; (2) low interest rates, QE, and a flood of global liquidity compressing margins in institutional lending; (3) lower fees across both lending and wealth management products, and; (4) regulatory changes impacting banks' ability to generate trading income.

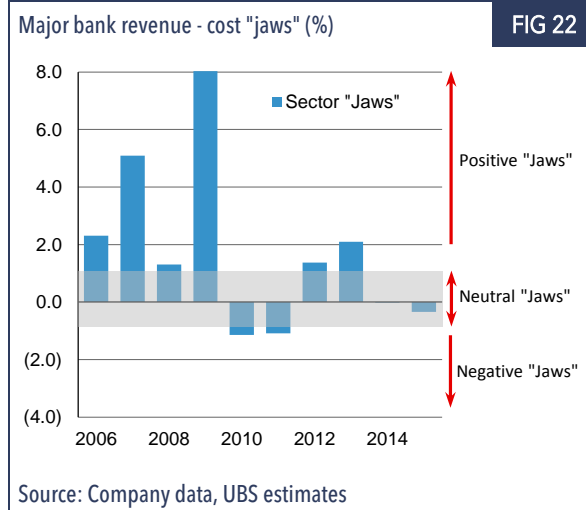


Interestingly, over the last decade, banks have proven to be effective managers of their net interest margins by repricing business loans post-GFC and managing mortgage margins to protect revenue. However, with acute pressure in non-interest income, costs have been an area of renewed focus.

Using technology to drive efficiency benefits

Investment in productivity initiatives by the banks has taken a variety of forms – from major projects (CBA's Core Banking Modernisation, NAB's NextGen & Simplification Programs, WBC's Strategic Investment Priorities) to more targeted efficiency programs (Smart ATMs, branch refreshes, automated origination, mobile). Overall, major sector investments are normalising, as highlighted by the return to trend levels of software capex after an elevated 2010-2013.

Management often tend to talk of targeting positive "Jaws", the difference between revenue and cost growth. At a high level, management are setting costs for the revenue environment. Given the banks have a cost to income ratio of around 43.5%, a better than 'neutral' outcome on "Jaws" should deliver growth in pre-provision profits for banks – hence the focus.



Despite the significant investment spend over the last 5 years, most of the cost outcomes delivered by banks have been evolutionary rather than revolutionary given revenue pressures have been benign.

The question of whether we see more material moves on costs from banks will depend largely on the revenue outlook. If push comes to shove and the banks are faced with structural revenue pressures similar to those of the 1990s, further cost reductions would be inevitable. With a cost base of \$35bn, there is a huge amount of excess in the system, and plenty of legacy channels still to shut down.

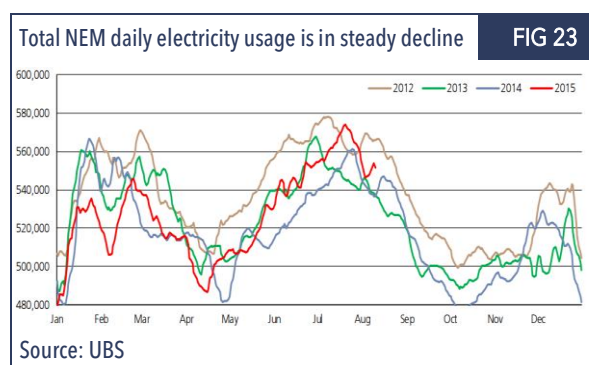
Although branches do remain a dominant channel, consumers are comfortable performing a range of banking tasks through digital channels. Everyday banking transactions are the most common transactions carried out using mobile phones. Carrying out banking tasks using social media still represents a small fraction of digital channel usage, although the take up is gradually improving.

The implication of the reducing prominence of the branch network is that banks will need to have a plan to rationalise and/or re-configure their branches. While we would expect to see some further declines, it is unlikely that branches will become obsolete, rather they will adapt and their purpose will change from carrying out everyday banking transactions to focusing on more complex needs.

Case study 5: Australian electricity utilities

Utilities are one of the last sectors to come to mind with respect to technological innovation – yet the entire industry is currently being reshaped and the long-term sustainability of the incumbents' business model is being called into question.

There are a number of structural factors putting top-line pressure on the established retailers (AGL Energy, Origin Energy and the unlisted EnergyAustralia). The key issue is that generation capacity exceeds demand, with generators struggling as they face lower wholesale prices and competition from subsidised renewables operating at no short-run marginal cost. Therein lies the controversy surrounding the review of the Renewable Energy Target (RET) that is intended to incentivise the build-out of renewables – which of course is not needed in an already oversupplied electricity market and in effect is instead displacing existing thermal generation. The excess in generation capacity has been exacerbated by the installation of solar panels in the residential market. Demand is falling each year as manufacturing and industrial sectors consume less energy and households become more energy efficient (**Fig 23**).



The issues extend even to the largely predictable regulated utilities space (the 'poles and wires', or distribution and transmission assets). Network costs, which constitute around half of retail electricity prices, have been the largest contributor to rises in electricity prices in recent years. With the intention of earning regulated returns on larger asset bases, regulated utility companies undertook significant investment in network infrastructure on the assumption that electricity demand in Australia would keep increasing as it always has. It has been evident that this so-called 'gold-plating' has been unnecessary in the face of continuously declining electricity demand in recent years, with the Australian Energy Regulator now clamping down on the operating efficiency and capital intensity of these businesses.

With top-line growth slowing, both the vertically integrated retailers and the regulated utilities have been prompted to recognise the need for change. AGL Energy and Origin Energy both recently flagged cost-out and the impact of technology on the future of the sector as areas of focus. We summarise the implications for both stocks below, as well as a collective note on the regulated electricity utilities.

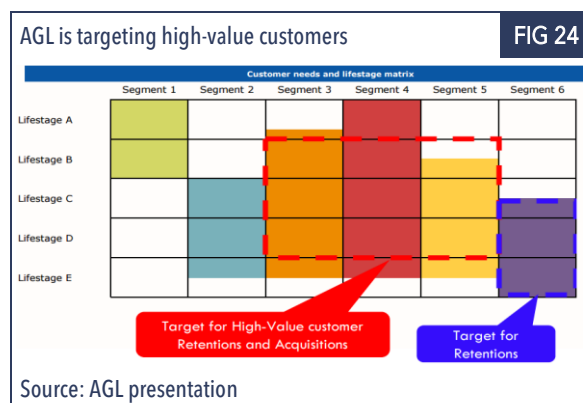
AGL Energy

The retirement of long-time CEO Michael Fraser, replaced in January by the American Andrew Vesey marked a notable shift in strategy for AGL; appointing an 'outsider' as CEO can generally be seen as a catalyst for change.

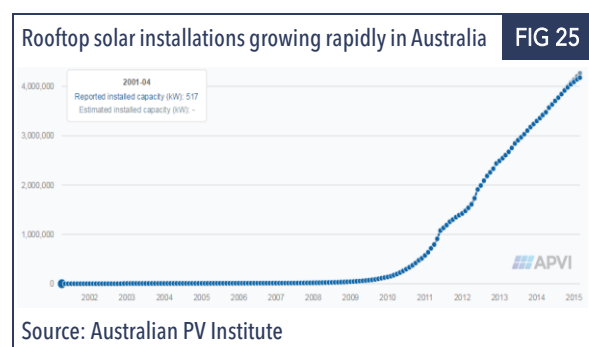
In April AGL released a greenhouse gas policy, stating that it will not extend the operating life of any existing coal-fired power stations and 'decarbonise' generation entirely by 2050 – quite a turn-around considering the company's new 'prized asset' is its recently acquired coal-fired Macquarie Generation power plants. AGL have subsequently outlined a more transformative roadmap involving material cost reductions and asset divestments, while their recent review of the upstream business confirmed a definitive shift to a 'purer' utility model.

More tellingly this recent presentation was AGL's first public acknowledgement that the structural decline in electricity consumption (driven by efficiency gains and continued take-up of rooftop solar) and elevated competition in the retail market will require a change in strategy.

AGL's management team have indicated a pointed focus on technology going forward. They intend to be first to market with digital offerings in the sector as a key point of differentiation, including electronic billing and a smartphone application to track consumption. IT system upgrades have allowed them to segment the market and target high-value customers for retention/acquisition rather than continuing to rely on heavy discounting to remain competitive (**Fig 24**).



A “New Energy” division has been established, which is intended to position AGL for this long-term industry change. Management are aiming to foster a more anticipatory culture – somewhat ironic from a company whose livelihood rests on fossil fuel generation. AGL already have a retail rooftop solar offering (albeit they only hold ~1% market share in a heavily fragmented market) and intend to extend this. Solar penetration is particularly low in the commercial and industrial sectors, which is where the company identifies the biggest opportunity. There is also a clear future in electric vehicles, and AGL have entered into a partnership with Mitsubishi to roll out solar charging stations.



Solar installations will be complemented by a battery storage option, which AGL sees as an opportunity to smooth electricity demand by reducing peak consumption. The final piece of the puzzle is smart metering, which is essential in order to integrate solar and battery technologies. In Victoria all households already have a smart meter but it is not yet compulsory in other states. Being an accredited installer, AGL is already positioned to get a head start with a target of 1 million installations. It is clear that AGL’s end-game is to use its scale and ongoing customer relationships to provide an integrated service whereby they can lock customers into contracts to reduce churn, and take advantage of the wealth of data provided by smart meters.

Origin Energy

Hot on the heels of AGL’s strategy update, Origin held its own Energy Markets investor day. Unsurprisingly, much of the rhetoric was the same: cost out, a pivot towards renewable generation, offering integrated solar products (including battery storage and EVs) and improved brand perception. The focus on cost reduction was more muted than that of AGL, although we argue that there is greater scope for Origin to benefit from this being a less efficiently run business than AGL.

Origin also talked about providing integrated and managed solar/battery/EV systems to both residential and corporate

customers. Currently Origin are the second-largest rooftop solar installer (by cumulative installations over the last 10 years), and they are planning to market this to customers more aggressively. They also have an internal smart metering business called Acumen Metering, however progress to date has been limited and Origin seemed to express less enthusiasm on expanding the smart metering business than with AGL.

The company’s troubled IT systems upgrade is now behind them and they are working on leveraging the new capabilities. One example of this would be the move towards an ‘Omni’ customer experience, whereby customer interactions can transfer seamlessly between different channels (for instance a customer seeking assistance through live chat can be redirected to a call with customer service without having to give all of their details / explain the problem again). Origin is also working on a smartphone app due to roll out over the next few months and is placing a greater focus on interacting with customers through social media including responding to customer complaints in order to improve their brand image.

We identify further opportunities for both AGL and Origin to adapt to changes in consumer preferences, for example by leveraging their brand to bundle energy with broadband/telco services in order to reduce customer churn (which Origin have flagged as a possibility, and which has proven successful in NZ) and through low-touch products such as an online-only retail offering from Powershop for budget conscious consumers.

Regulated utilities

As previously mentioned, electricity demand is declining in Australia which poses two problems for the regulated utilities: 1) a significant proportion of network charges are variable based on (now falling) usage, which puts downward pressure on earnings; and 2) there is now less justification to expand the networks’ asset bases with regulated returns therefore limiting top-line growth. There is little that can be done to combat the latter, but the first point will see the economic sustainability of the electricity networks evaporate in the long run.

One main driver of lower demand in Australia is increased penetration in rooftop solar installation which lowers demand from the grid during off-peak times when solar panels are generating (middle of the day); however battery storage, which will become more affordable through time (for example Tesla’s mass-market Powerwall battery which analysts estimate could have as little as a seven-year payback) will potentially also flatten out peak demand.

As the economics of both solar and storage become more attractive, networks will be forced to increase the fixed component of tariffs in order to recoup revenue, which will in turn only further incentivise a complete move 'off-grid' in what is commonly touted as a 'death spiral' for the networks. The companies are lobbying for legislation to provide a more favourable tariff structure, and although the regulator acknowledges the issue at hand there is no clear solution given the problem will only manifest many years from now.

As seen in Germany, an increased share of the generation mix coming from renewables may also necessitate upgrades to both the distribution and transmission networks to account for cases in which generation by end-users exceeds demand and there is actually a net inflow of electricity back to the grid.

However, not all is dire – an opportunity does present itself in terms of smart meter installations. The mandatory rollout in Victoria places the Victorian networks (ex-AusNet which is having issues with its chosen technology) at an engineering advantage to roll out smart meters across the rest of Australia. Spark Infrastructure has already expressed interest in doing so. In an environment of declining electricity demand, such diversification of earnings should be seen as favourable.

Performance Review

After a challenging start to FY15, fund performance improved in the second half of the financial year and losses were largely recovered. While we are never satisfied with portfolio returns that fall below our stated targets, we were able to deliver a positive gross return (before fees and costs) for the 12 months to June 30 in respect of the Market Neutral Strategy; preserving intact our track record of having delivered such a result in every financial year since 2008. This is a feat achieved almost exclusively from stock selection as opposed to buoyant share market returns to which the Funds have limited exposure.

In analysing the causes of the weaker performance in the first half of FY15, it is clear that a number of factors and themes were at play. By January 31, which marked the end of a string of negative monthly returns, the short portfolio had performed largely in line with the market while the long portfolio significantly underperformed. Weaker performance from the long portfolio was a result of two key themes in particular.

When market leadership converges around a narrow group of shares; in this case high yielding shares with defensive earnings, active investment managers generally struggle to outperform. As a fundamental investor with a bias towards value and quality, the Funds have not owned many of the 'expensive defensives' that have been so strongly favoured by investors looking to supplement anaemic portfolio yields.

The portfolios delivered very strong returns in FY13 and 14, due in large part to short positioning in respect of mining and energy. Having closed many of these profitable short positions in FY14, the portfolios were left with modest long exposure to a handful of small mining companies, positions

that were supported by sound fundamentals and attractive prices. Unfortunately, as the rout in global commodity prices continued, several of these small positions moved against the Funds and contributed to poor performance.

Fortunately the funds operate within tight risk controls which limit losses attributable to individual positions. As such, portfolio losses were modest and able to be recovered in the final months of FY15. The benefit of a fully hedged structure can be clearly seen when share markets are volatile. As share markets globally were buffeted by problems in Europe and China, our portfolios were insulated and performed independently of these external forces. It has been stock selection, guided by deep fundamental research that has driven returns in recent months, with volatility providing the opportunities to build on existing positions and initiate new ones.

Stock selection within industrial shares has been consistently profitable and contributed positively to portfolio returns in FY15. The Funds perform best when the portfolios are populated with a diverse range of profitable investment ideas. While ideas were harder to come by in 2014, the last six months have proven more fruitful and the portfolios have benefitted from a range of new positions and investment themes.

We are optimistic about the opportunities that lie ahead and are relishing the ability to exploit compelling investment ideas in offshore markets. FY16 promises to be an interesting year for share markets around the world with major macro-economic issues still unresolved. We are confident that the funds are well-positioned and that our investment strategy can deliver attractive returns irrespective of what happens in the broader share market.



WATERMARK
FUNDS MANAGEMENT



**AUSTRALIAN
LEADERS
FUND**

Company at a Glance - June 2015

ASX Code	ALF
Fund Size	AU\$328m
Fund Strategy	Variable Beta
Share Price	\$1.23
NTA Before Tax	\$1.32
Shares on Issue	256.3m
Dividend (1H15)	5 cents
Dividend Yield (annualised)	8.9%

Net Tangible Asset (NTA) Backing

	May 15	June 15
NTA Before Tax	\$1.29	\$1.32
NTA After Tax	\$1.30	\$1.33

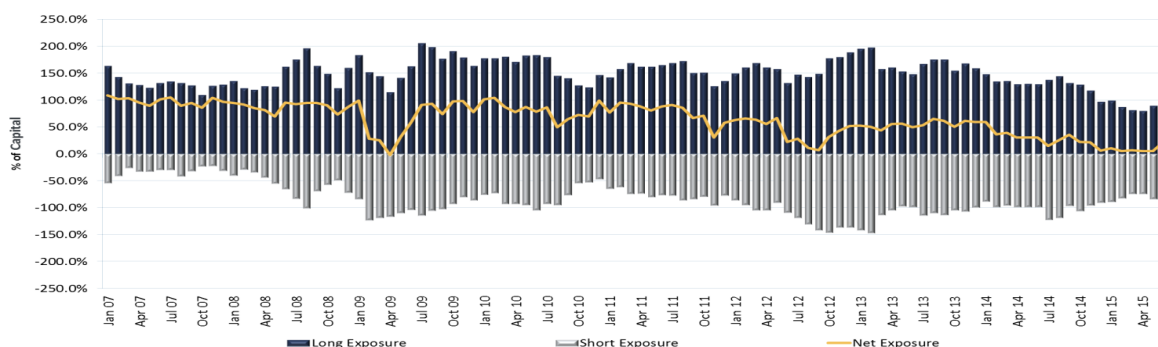
Gross Portfolio Structure

	May 15	June 15
Long Exposure	89.9%	99.6%
Short Exposure	-84.7%	-77.5%
Gross Exposure	174.6%	177.1%
Cash	94.8%	77.9%

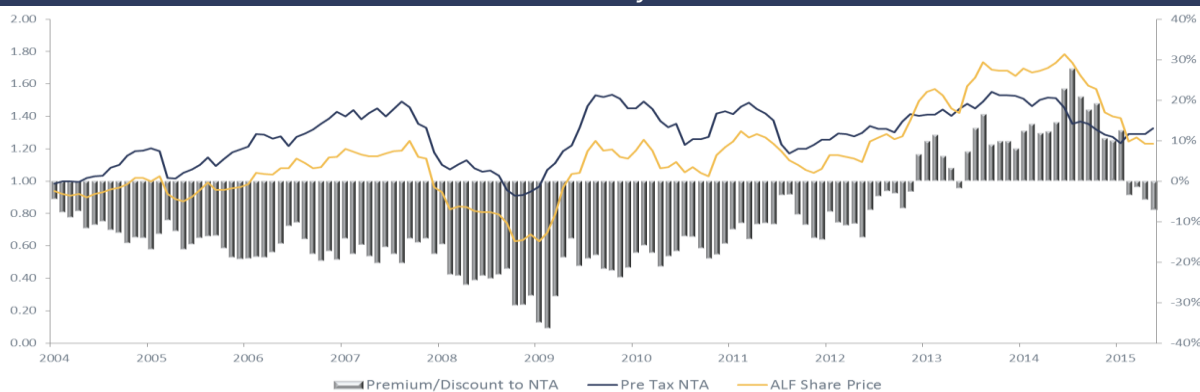
ALF Performance

	1 Mth	6 Mths	1 Yr	3 Yrs (pa)	5 Yrs (pa)	7 yrs (pa)	S.I. (pa)
Portfolio Return (net)	3.1%	6.4%	-3.4%	16.3%	13.6%	15.2%	14.1%
All Ords Accum Index	-5.4%	3.3%	5.7%	14.5%	9.4%	4.8%	9.0%
Outperformance (net)	8.5%	3.1%	-9.1%	1.8%	4.2%	10.4%	5.1%

Net Equity Exposure



Historical Premium/Discount to NTA History



Fund at a Glance – June 2015

Fund Size	AU\$35.2m
Strategy FUM	AU\$116.2m
Fund Inception Date	August 2012
Fund Strategy	Equity Market Neutral
Application/Redemption	Daily
Management Fee	1.5%
Performance Fee	20%
Benchmark	RBA Cash Rate

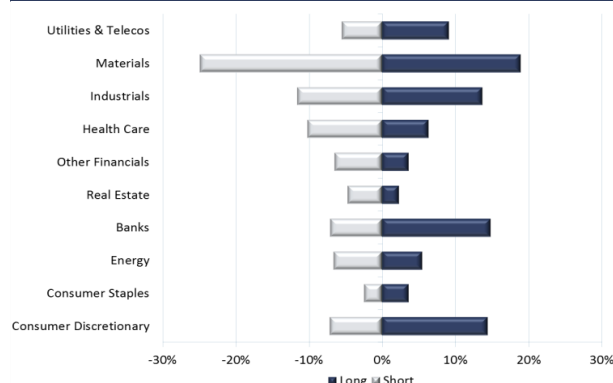
Return Characteristics¹

Positive Months	69.6%
Maximum Drawdown	-9.04%
Sharpe Ratio	1.1
Sortino Ratio	3.66
Standard Deviation	9.0%
No. Long Positions	67
No. Short Positions	58
Gross Exposure	179.6%

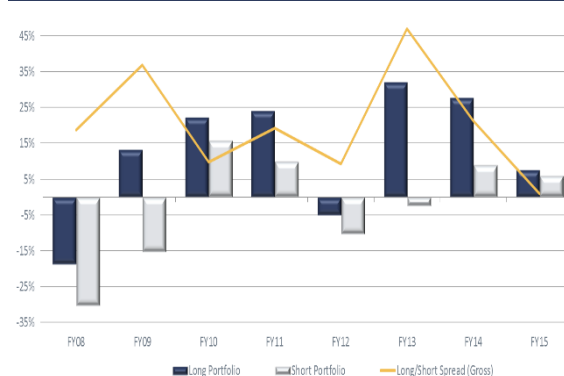
Performance²

	1 Mth	6 Mths	Fin. YTD	1 Yr	2 Yrs (pa)	S.I (pa)
WMNT (net return)	3.4%	6.6%	-1.9%	-1.9%	6.2%	14.0%
RBA Cash Rate	0.2%	1.1%	2.4%	2.4%	2.5%	4.3%
Outperformance	3.2%	5.5%	-4.3%	-4.3%	3.7%	9.7%

Sector Exposures



Long/Short Spread³



Monthly Net Performance (%)

Cal. Yr	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	Annual
2012	-	-	-	-	-	-	-	1.36	0.97	0.00	6.51	2.88	-
2013	-0.71	0.21	4.60	1.55	5.83	5.31	1.11	2.57	1.43	1.86	0.35	-0.06	24.05
2014	1.71	1.45	-1.17	2.80	1.21	0.84	-4.38	-1.77	2.52	-1.57	-1.58	-1.32	-1.26
2015	-1.18	0.70	3.23	0.96	-0.61	3.39							-

¹ Return Characteristics are in relation to the market neutral strategy using long/short return series recorded from April 2008

² Performance data is net of all fees and expenses. The Fund's inception date is August 2012

³ Long/Short spread shows the gross performance of the long and short portfolios. The Fund makes a profit where the long portfolio outperforms the short portfolio, after the payment of fees. Returns prior to the Fund's inception date are based on return series from the long and short portfolios of the Australian Leaders Fund Ltd in a market neutral structure

Company at a Glance - June 2015

ASX Code	WMK
Fund Size	AU\$81.0m
Fund Strategy	Equity Market Neutral
Share Price	\$0.81
NTA Before Tax	\$0.99
Shares on Issue	84.1m
Dividend (1H15)	2 cents
Dividend Yield (annualised)	5.55%

Net Tangible Asset (NTA) Backing

	May 15	Jun 15
NTA Before Tax	\$0.96	\$0.99
NTA After Tax	\$0.96	\$0.99

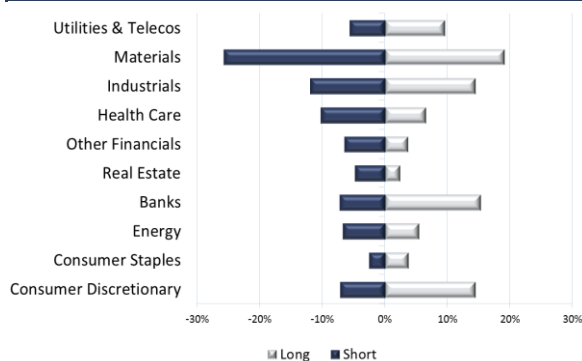
Gross Portfolio Structure

	May 15	Jun 15
Long Exposure	98.3%	94.6%
Short Exposure	-92.2%	-89.3%
Gross Exposure	190.6%	183.9%
Cash	93.9%	94.7%

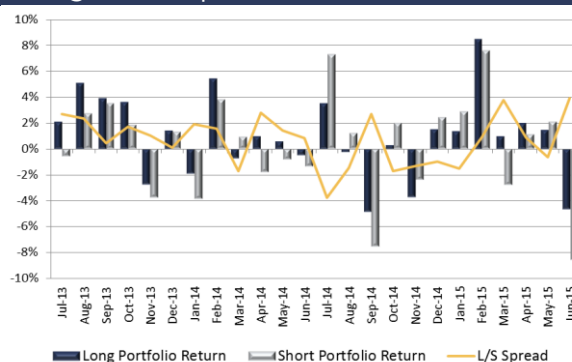
WMK Performance

	1 Mth	6 Mths	1 Yr	S.I. (pa)
Portfolio Return (net)	3.30%	6.15%	-1.84%	4.90%
RBA Cash Rate	0.17%	1.11%	2.39%	2.47%
Outperformance (net)	3.14%	5.04%	-4.23%	2.43%

Sector Exposures

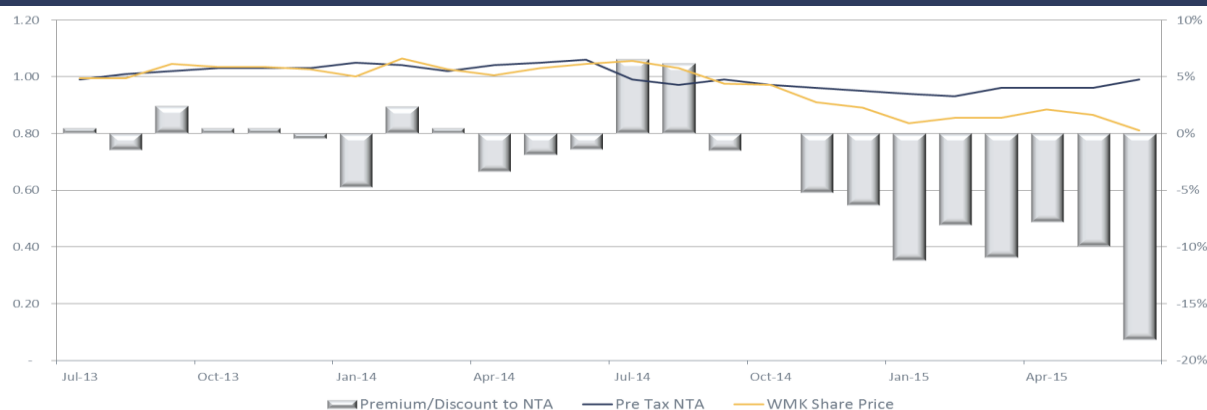


Long Short Spread*



* Long Short spread shows the gross monthly performance of the Company's long and short portfolios. The difference between the two represents the gross performance of the portfolio as a whole. The company will make a profit where the long portfolio outperforms the short portfolio, after the payment of fees and expenses

Historical Premium/Discount to NTA



Notes

Notes



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