



The Leading Edge

QUARTERLY REPORT • March 2016

The Australian banks are once again under the spotlight. In this edition of *The Leading Edge* we consider the regulatory pressures building in this important sector.

Level 6, 139 Macquarie Street, Sydney NSW 2000

TEL (02) 9252 0225 • FAX (02) 9252 1220 • info@wfunds.com.au • www.wfunds.com.au

This report has been prepared by Watermark Funds Management Pty Limited.

This report is for distribution only under such circumstances as may be permitted by applicable law. It has no regard to the specific investment objectives, financial situation or particular needs of any specific recipient. It is published solely for informational purposes and is not to be construed as a solicitation or an offer to buy or sell any securities or related financial instruments. No representation or warranty, either express or implied, is provided in relation to the accuracy, completeness or reliability of the information contained herein nor is it intended to be a complete statement or summary of the securities, markets or developments referred to in the report. The report should not be regarded by recipients as a substitute for the exercise of their own judgement. Any opinions expressed in this report are subject to change without notice. The analysis contained herein is based on numerous assumptions. Different assumptions could result in materially different results. Watermark Funds Management Pty Limited is under no obligation to update or keep current the information contained herein. Past performance is not necessarily a guide to future performance. Estimates of future performance are based on assumptions that may not be realised.



Justin Braitling
 Portfolio Manager

Message from the CIO

It has been a perilous start to 2016 for equity markets, with the MSCI World index falling precipitously – down 12% by mid-February – before rallying strongly into March to end flat in US dollar terms for the quarter. While the Australian share market also recovered early losses as mining shares rallied, the overall market finished the quarter lower with bank shares losing more than 10% of their value. The Australian share market continues to struggle even as offshore markets have risen, with further weakness in banking shares and the broader industrial sector battling a rising Australian dollar.

Despite some of the recovery in share prices the global economy is still mired in structural stagnation, which is the sentiment that Christine Lagarde (Managing Director of the International Monetary Fund) captured in a recent speech:

"The good news is that the recovery continues; we have growth; we are not in a crisis. The not-so-good news is that the recovery remains too slow, too fragile, and risks to its durability are increasing".

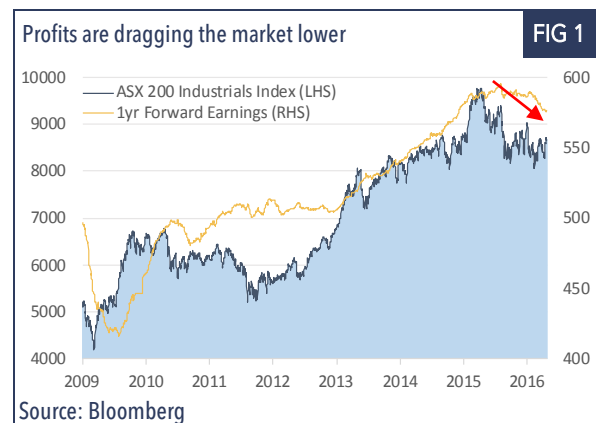
With much of the growth impetus through this cycle coming from emerging markets (EM) the expectation was that as EM economies slowed advanced economies would pick up the "growth baton" – but as Lagarde indicated, that has not happened.

We have seen steep cuts to economic forecasts so far this year with EM stress, weaker commodity prices and tightening policy all conspiring to weigh on growth. We may well have seen the worst of these headwinds though, as the Chinese economy has stabilised, commodity prices most likely bottomed in the first quarter and the pace of policy tightening in the US has been pushed back.

The strong US dollar continues to constrain the US economy, which has been expanding at a sub-par rate of 2-3% for some time. The industrial economy is burdened with surplus inventories and weak investment. A strong labour market should support activity in the medium term, however

as employment conditions improve further the Federal Reserve will be forced to embrace a more 'hawkish' and less market-friendly stance on policy. Conversely, central banks in Europe and Japan may look to experiment with more radical liquidity measures to counter deflation, maintaining upward pressure on the US dollar. This backdrop of softer growth, divergent monetary policies, a strong US dollar and weak commodity prices will generally place downward pressure on equities.

Stepping back and looking at the path of corporate profit growth since the post-GFC recovery began seven years ago, you can see how Australian industrial shares (excluding resources) have followed earnings higher before stalling in 2015 (Fig 1).

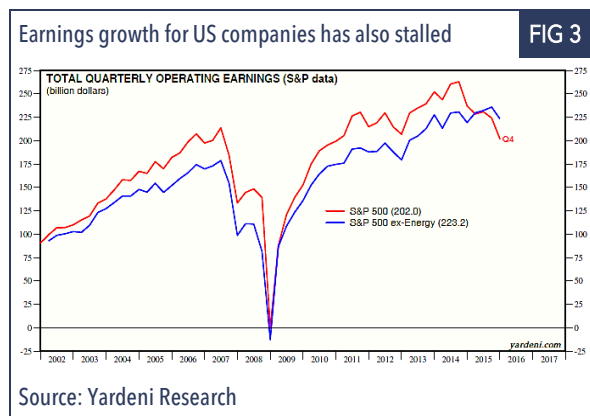
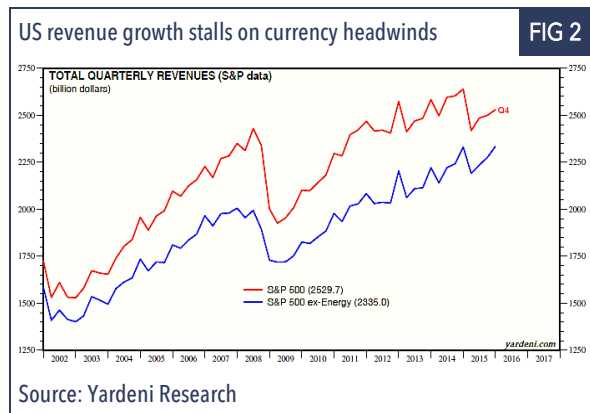


As the outlook has softened – particularly for commodities – and profit estimates have been cut, shares have moved lower. While you would expect profit forecasts for mining shares to fall along with commodity prices, you may be surprised by the extent of the downgrades across industrial shares. These moves have been seen not only across the obvious cyclical candidates exposed to a softening economy but also in typically defensive sectors such as healthcare, utilities, groceries and telecom. We have written extensively in recent quarters about the challenges facing many of these sectors. Profit forecasts for the important banking sector are also under pressure as margins are squeezed by higher funding costs and loan losses.

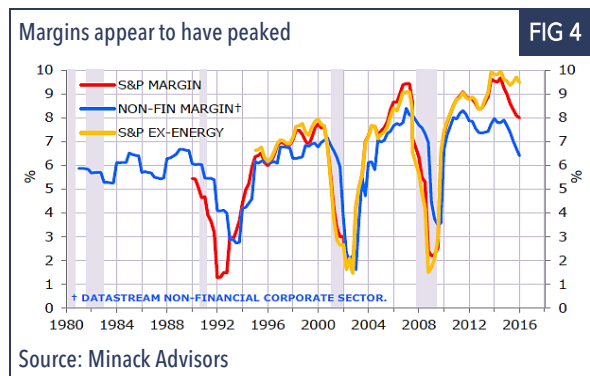
We don't see these negative trends abating in a hurry, which is a key reason we are cautious on the share market. As profits decline the price of shares will surely follow, and many of the large companies are struggling to grow.

The US share market is challenged by similar trends. The S&P 500 group of companies derive 40% of their revenues offshore, and a stronger dollar along with weakness in emerging markets is putting downward pressure on revenues reported in US dollar terms (Fig 2). Even within the

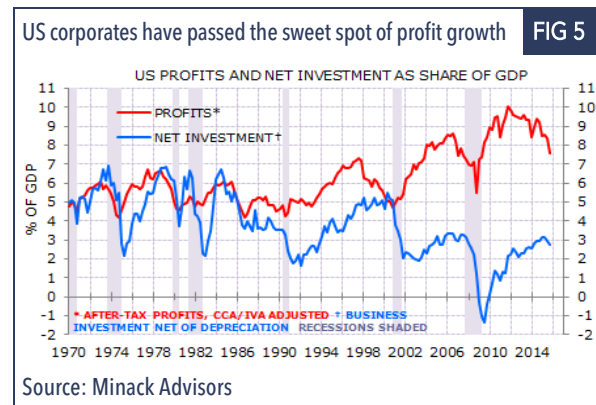
US, sales growth has stalled amidst falling commodity prices and weak investment spending in the energy sector. The industrial economy as mentioned is going through a destocking cycle, further weighing on revenues.



Margins are back at peak levels (**Fig 4**) seven years into the recovery, and so this inability to increase them further has seen profit growth stall – even excluding the clear weakness in the energy sector. Typically during the early stages of recovery in a business cycle companies capture most of the incremental value from increasing sales and they delay investments in capital and labour. As the cycle matures and factor markets tighten, margins inevitably peak as labour and other resources begin to capture a larger share of the incremental growth.

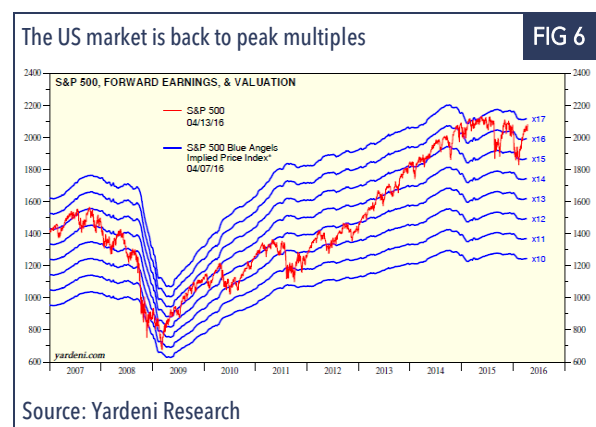


You can see this in **Fig 5**, which shows that the profit share of income has peaked and is now rolling over. Labour as a share of total income (inversely related to profits) has been falling throughout this cycle. Margins appear to have peaked and labour rates are now accelerating, which we believe will cause labour's share of GDP to increase from here.



While wage pressures will force a further tightening in monetary policy, many of these other pressures will abate as we move through 2016. We have probably seen the worst of the US dollar strength, inventories will rebalance and oil markets will strengthen later in the year allowing revenue growth to resume. Having said that, profit growth is likely to be quite modest given the backdrop of soft global growth and peaking profit margins.

With US shares trading back at higher multiples of earnings (**Fig 6**) and given this soft profit outlook, we see limited upside here for the important US share market unless profit growth miraculously resumes on the back of a weaker dollar and stronger oil prices.



Returning to the Australian outlook, our base case is for the economy to muddle through in the absence of any adverse external shock. We do sense that the economy is at an important juncture however. The first-round effects of the mining downturn have been working through the economy

for some time, but commodity markets have moved lower again in early 2016, which will put further pressure on this important sector. The steep drop in mining-related investment will soon face us as projects are completed.

While income growth in the household sector has been weak, spending has been buoyed by inflated asset markets resulting in a falling savings rate. As households are already heavily indebted, there is a limit to this dissaving. With the property cycle now rolling over and an election looming, some troublesome signs of weakness in spending are emerging. The government has also been put on notice by rating agencies to improve the fiscal path or risk losing the country's coveted AAA credit rating.

On the positive side of the ledger, corporate balance sheets are solid, foreshadowing further capital management, and valuations are more reasonable following the recent pull-back. The mining and energy sectors that were oversold in February are now benefiting from early signs of growth picking up in China and a rebalancing of oil markets. The risks in the short-term appear to the upside in these sectors. On the other hand, low growth and structural headwinds in the other key sectors discussed will contain any sustainable upward move in the broader share market.

We are left with a less than favourable outlook for shares where we think returns will be low in the medium term, with most of this return coming through dividends.

Regulatory pressures ahead for Australian banks

Regulatory change has been a key driver of bank share prices over the last two years, and this looks set to continue. The banks are subject to a number of rules mandated by regulators. Changes have and will continue to be most impacted by APRA's interpretation of Recommendation 1 of the Financial System Inquiry's (FSI) Final Report from December 2014, which stated:

"Set capital standards such that Australian authorised deposit-taking institution capital ratios are unquestionably strong".

The FSI defined "unquestionably strong" as having capital ratios that are in the top quartile of large internationally active banks. APRA supports the FSI recommendation that capital ratios should be "unquestionably strong", however they have taken a broader approach to define "unquestionably strong", which includes incorporating a range of recommendations from global regulators like the Basel Committee.

The Basel Committee is currently focused on finalising the implementation of its post-crisis reforms. APRA's Chairman recently stated in January that, "Over the year ahead, we'll be watching how the international capital framework is finalised with a view to establishing an 'unquestionably strong' and robust set of domestic capital requirements for Australian deposit-takers".

Banks hold capital against their outstanding loan exposures as a buffer against losses. However, not all loans have the same risk profile. Mortgages have historically had very low loss rates for the banks relative to other lending classes such as credit cards. As a result, banks will "risk weight" their loans based on the probability of default and loss given default, and then determine how much capital to hold against them. For example, a bank may have a risk weighting of 20% for a mortgage but 60% for a business loan, which effectively means the risk profile of the business loan is three times higher.

"Advanced" banks are allowed to determine their own appropriate risk weightings based on internal models while less sophisticated banks are required to use the "standardised" risk weights which are set by the regulator. In recent times, risk weightings have continued to decline, and have now significantly diverged from the risk weightings specified for those banks using the "standardised" risk weights. As a result, "advanced" banks are now holding far less capital than their "standardised" counterparts, with the major banks risk weighting some

mortgages at as little as 4%. In Fig 7, the divergence between the risk weights for the Australian major banks and standardised banks is apparent.

Current vs. standardised loan risk weight by category (%) FIG 7

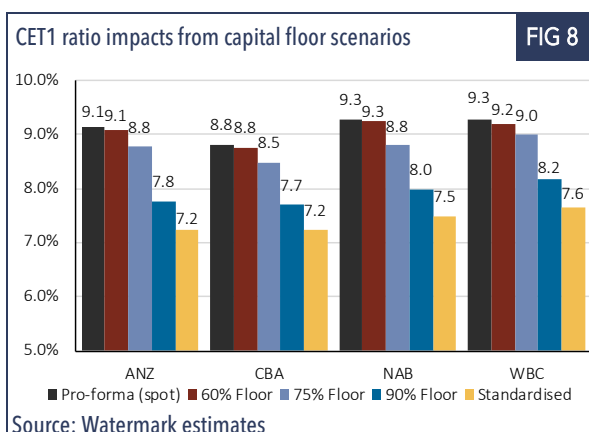
Risk Weights	ANZ	CBA	NAB	WBC	Standardised
Corporate	54.3	57.7	48.6	60.3	75.0
Mortgage	24.1	24.0	27.5	24.7	35.0
of which: Owner-Occ	24.1	24.0	27.5	24.7	35.0
of which: Investor	24.1	24.0	27.5	24.7	90.0
Qualifying Revolving	34.2	34.2	33.6	29.7	75.0
Other Retail	54.3	129.6	77.4	83.2	75.0
Total	40.7	52.3	42.2	43.4	

Source: Company data, Watermark estimates

There is still a lot of uncertainty around where all the regulation will settle, however we have attempted to quantify some of the potential changes. In December 2015, the Basel Committee released their second revision to the Standardised Approach for credit risk. The Basel Committee followed this paper up in March 2016 with a consultative document covering internal model approaches. There remains uncertainty in which path the Basel Committee will take, however it is useful to explore some scenarios.

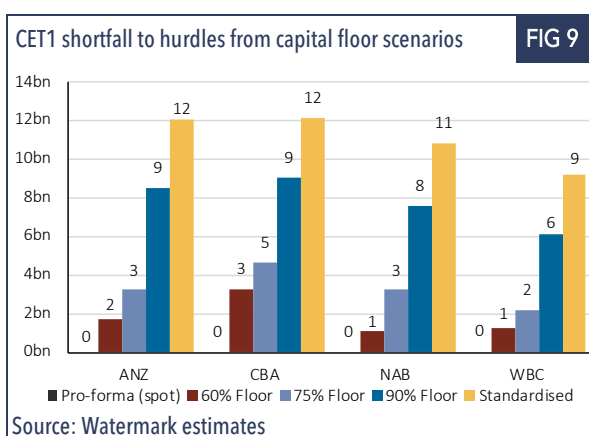
'Advanced' banks may be required to hold the higher of their internally modelled capital, or capital defined by the revised standardised approach with a haircut applied. This haircut is commonly known as a "capital floor". A capital floor effectively limits the potential divergence between risk weightings in the standardised model and those generated by the bank's internal models. It is worth noting that the US banks are currently using a 100% capital floor, which means that they are either using a standardised risk weighting or an even higher risk weighting if deemed necessary by their internal models. This is in stark contrast to most other "advanced" banks in the world and provides them with a very high hurdle to surpass.

In the following section, we run some broad scenarios covering potential impacts on risk weights and capital, assuming the Basel Committee introduces capital floors. If we take the existing loan category risk weights and apply the standardised assumptions from Fig 7, taking into account capital floor scenarios of 60%, 75%, 90% and 100% (i.e. standardised), we find a range of capital impacts (Fig 8).



The scenarios suggest that at a 60% floor, there is only a moderate impact to capital ratios. However, as the floor is lifted from 60% to 75% and through to 90%, the capital impact increases exponentially. At a 90% floor, the capital impact ranges between 1.1-1.3%. This translates to shareholder dilution of at least 8% in addition to any discount at which the new shares would need to be issued.

The final determination on where the capital floor is set (and perhaps more importantly how it will actually be applied) is very much uncertain and leads to a very wide range of potential capital outcomes. Assuming that the Basel Committee decides to apply aggregate capital floors to "advanced" banks, the capital shortfall could vary between \$7bn and \$31bn depending on where the floor is set as seen in Fig 9. This translates to dilution for existing shareholders of at least 2-8% as the banks are forced to close this shortfall.



If we categorise these scenarios as "Light" (60% floor on loan category risk weights), "Moderate" (75% floor on loan category risk weights), and "Harsh" (90% floor on loan category risk weights), the capital shortfalls under these

scenarios are included in Fig 10. In aggregate, the "Light" scenario could result in a CET1 shortfall of \$7bn (2% dilution), \$13bn for the "Moderate" scenario (4% dilution), and \$31bn for the "Harsh" scenario (8% dilution).

Capital shortfalls under Light, Moderate, Harsh scenarios **FIG 10**

CET1 Capital Shortfall (\$bn)	ANZ	CBA	NAB	WBC	Sector
Light	1.7	3.3	1.1	1.2	7.3
Moderate	3.2	4.6	3.2	2.2	13.2
Harsh	8.5	9.0	7.6	6.1	31.2

Capital Shortfall as % of Market Cap	ANZ	CBA	NAB	WBC	Sector
Light	2%	3%	1%	1%	2%
Moderate	5%	4%	4%	2%	4%
Harsh	12%	7%	11%	6%	8%

Source: Watermark estimates

An additional layer of complexity that was introduced in the Basel Committee's consultative document in December 2015 was around residential investment properties. The Basel Committee has proposed that when the repayment of a residential investment property loan is "materially dependent" on the cash flows generated by the investment property, then a different much higher risk weighting should apply. The logic behind such a change is that an investment property is purchased by a consumer as part of an investment decision with a profit motivation rather than considering factors such as the utility of living in the property. As a result, there is minimal emotional attachment to an investment property and in the event of a downturn, the owner is likely to sell it with considerably less hesitation than a similar owner occupied property. Therefore, it is actually a commercial loan in nature and requires a higher risk weighting to reflect this.

The Basel Committee has given no indication on what may define this "material dependence", even suggesting it may vary across regions. While this has further muddled the water, we have run some scenarios on the basis that all investment property loans in Australia are materially dependent on rents to service the loan. This is clearly a harsh assumption, but the scenario is useful as a backstop. We find that applying differential risk weighting on investor property loans (estimated at 90% risk weight based on the standardised model), the range of capital impacts across the banks lifts from 1.1-1.3% to 2.1-2.5% as seen in Fig 11.

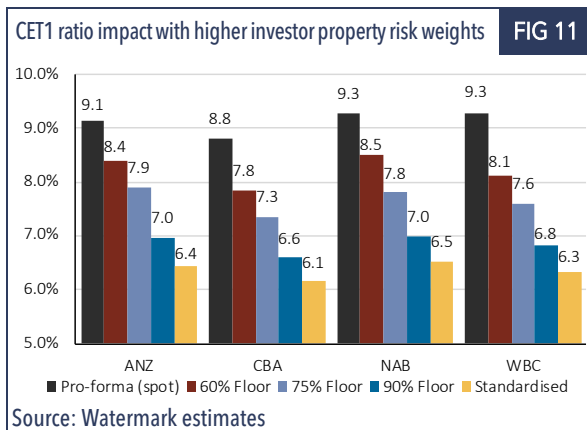
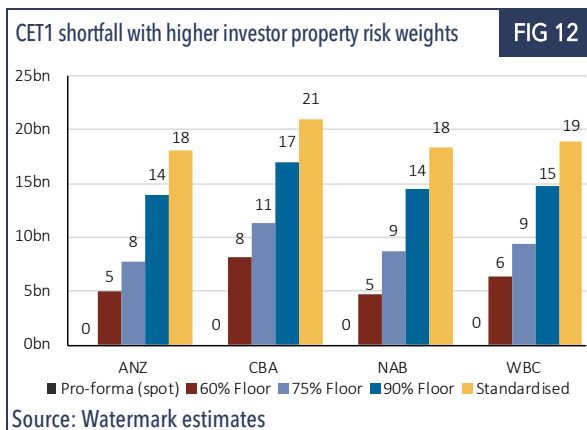


Fig 12 depicts the movements in capital shortfalls for the banks under this scenario. The capital shortfall would now range from \$24bn to \$60bn if the capital floor is set between 60% to 90% and all investment property loans are risk weighted at 90%.



Under this revised scenario, the capital shortfall for the industry moves to \$60bn (16% dilution) from \$31bn (8% dilution) in our previous scenario as seen in **Fig 13**. As a result of the banks' significant skew to investment property lending, the capital shortfall scenario is very sensitive to the assumption about the number of investor loans which are materially dependent on rents to service the loan.

CET1 shortfall with higher investor property risk weights **FIG 13**

CET1 Capital Shortfall (\$bn)	ANZ	CBA	NAB	WBC	Sector
Light	5.0	8.1	4.7	6.4	24.2
Moderate	7.8	11.3	8.7	9.4	37.1
Harsh	14.0	17.0	14.4	14.8	60.1

Capital Shortfall as % of Market Cap	ANZ	CBA	NAB	WBC	Sector
Light	7%	6%	6%	6%	6%
Moderate	11%	9%	12%	9%	10%
Harsh	20%	13%	20%	14%	16%

Source: Watermark estimates

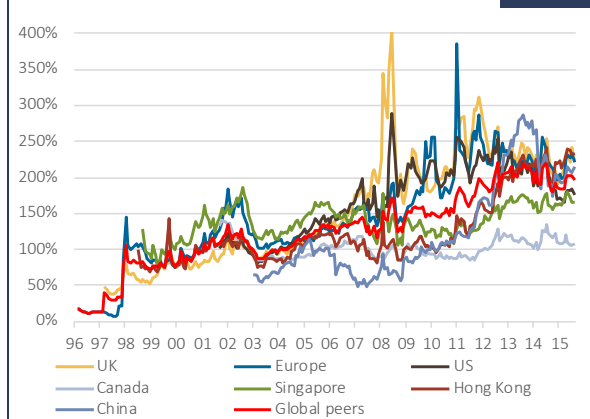
In conclusion, as the banks continue to increase their capital levels, shareholders will continue to face ongoing dilution. Additionally, both short-term and long-term wholesale funding costs are starting to increase for the banks. This puts downward pressure on margins as does ongoing discounting on standard variable rates in the mortgage market as banks compete aggressively to lend in an environment where customers are paying mortgages back faster given historically low rates. It is also likely that we are now at the bottom of the bad debt cycle which puts further pressure on earnings as bad debt charges rise. ASIC has also begun to investigate the banks on interest rate manipulation which has the potential to produce other misconduct claims. The UK and US experiences are good examples of the negative impacts that can occur as litigation costs and fines come to fruition. Therefore, we believe the environment for the Australian major banks is unlikely to improve from here.

Is there value in the banks?

The Australian banks have underperformed the market significantly over the last 12 months, having fallen 14.4% on a total return basis (including dividends). We often hear the view that the Australian major banks now offer good value on a P/E basis given the sector now trades below long term earnings multiples. However, we disagree with this view since earnings are distorted by bad debt charges which are in turn impacted by existing loan loss provisions and management discretion. Therefore, one should be cautious when using a P/E multiple for valuing a bank. In the following section, we have valued the Australian major banks using five more robust valuation methodologies rather than simply using a P/E multiple. These valuation methods include: 1) underlying profit multiple relative to history; 2) underlying profit multiple relative to the market's EV/EBIT multiple; 3) economic value added; 4) Price/Book premium/discount to international peers; and 5) a capital adjusted Gordon-growth model.

Fig 14 shows the Price/Book multiples of the Australian major banks relative to global peers. It is clear that the Australian major banks have experienced a significant re-rating on this basis over the last 20 years, moving from a ~50% premium to ~200% premium more recently. A large part of this re-rating has been warranted given the strong underlying fundamentals that have existed domestically. This was exacerbated during the depths of the financial crisis. However, it is important to remember that the Australian and Canadian banks benefited significantly from a commodities boom that occurred around the same time and helped sustain their respective economies. These economic stimulants are now becoming drags as commodity prices continue to decline. As a result, losses for the banks are expected to rise and growth will be tougher to achieve. The RBA recently noted that "lower commodity prices could indirectly reduce bank profitability in commodity-exporting economies by weighing on economic growth." In addition to this, the capital strain is worsening for both the Australian and Canadian banks as regulators force them to hold more capital to keep up with steadily increasing capital requirements throughout the rest of the world. Therefore, the significant premiums at which the Australian banks have previously traded relative to global peers are not warranted in the current environment.

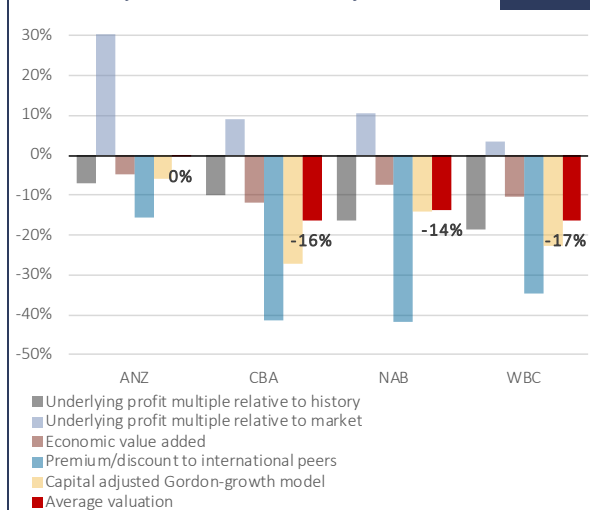
Australian major banks appear expensive vs. global peers **FIG 14**



Source: Reuters, Watermark estimates

Fig 15 details the summary of our valuations using each of the different methodologies. On average the major banks have further downside of 12% based on our analysis, however there is considerable divergence between each of the banks. It appears that ANZ's share price now reflects a lot of the challenges facing the business while the other three major banks still have considerable further downside.

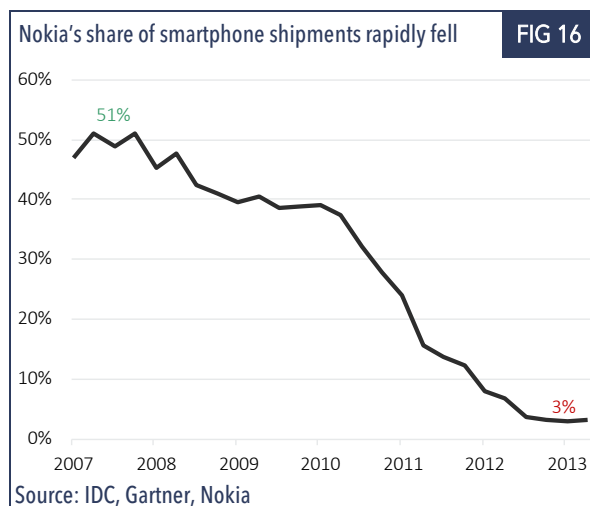
Australian major banks' valuation summary **FIG 15**



Source: Reuters, Watermark estimates

Nokia: Returning to its roots

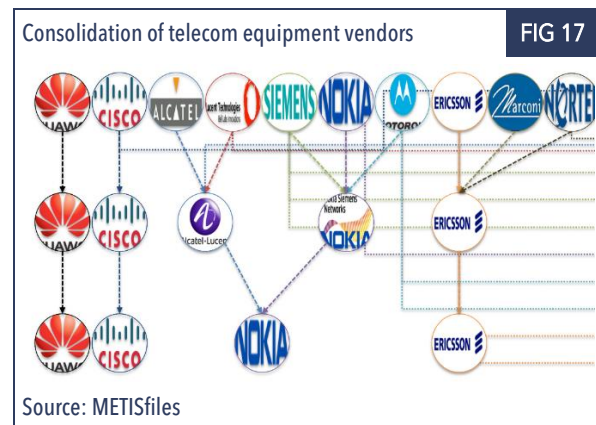
Nokia is likely a familiar name to most readers for its durable mobile handsets – but this is a business whose structure has significantly changed through time. In fact, Nokia's origins lie as a forestry and later rubber-producing company in the late 1800s. During the 1970s Nokia became involved with the telecommunications industry, and was instrumental in developing the first mobile standard (2G GSM) having launched the first mobile network in Finland in 1989 and the first GSM phone in 1992. Since then Nokia has been known as a leader in manufacturing mobile devices and telecom network equipment. The business model began to unravel following the launch of Apple's iPhone in 2007, which kick-started smartphone evolution and caught Nokia as well as other manufacturers of 'feature phones' off-guard (Fig 16). The company's share of handset sales fell from more than 50% to less than 5% in a matter of years, and this business was finally sold to Microsoft in 2013. Nokia also sold their popular mapping and navigation software HERE to a group of European car makers. So what is left of the business?



Nokia's earlier dominance in mobile handsets had largely come about as a result of their role in developing the GSM standard, with new features like international roaming, SMS and higher quality voice calls catalysing its uptake. This development saw the company become one of the leaders in telecom network equipment, which includes components like radios and network management software used by telecom carriers in their mobile networks. Post Nokia's numerous business divestments and investments, the company is now focused on their core competency in manufacturing network equipment.

20 years ago telecom was still a highly localised business. Carriers were focused on servicing their domestic markets, including the now large multinational carriers like Vodafone

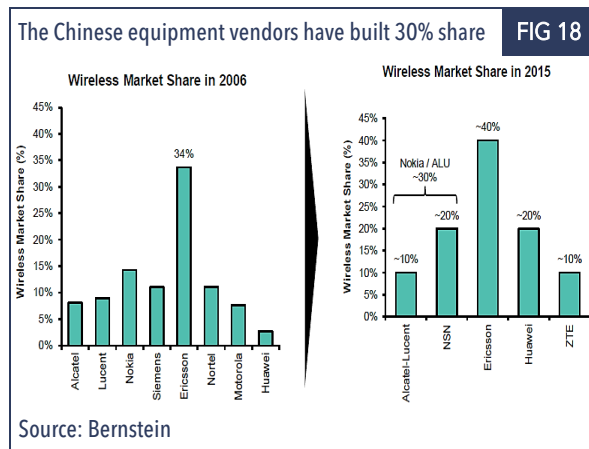
and Telefonica. The same held true for the equipment vendors – for instance Alcatel serviced the French carriers, Nokia and Ericsson serviced the rest of Europe, Marconi serviced the UK carriers, Lucent serviced the US and Nortel serviced Canada. This was generally not a competitive market as there were technical differences between the telecom networks in different countries – but this all changed with the development of the GSM standard, when the equipment vendors all developed ambitions to 'take telecom global'. The result was 15 firms competing with largely commoditised products, since equipment needs to be built to a standard. Profitability slumped, forcing rapid consolidation across the industry (Fig 17). Many of these deals unfortunately were marred by cultural clashes and strategic uncertainty. Nokia's part in this consolidation was initially a 50/50 joint venture combination with Siemens' networks business in 2006, which they later fully acquired in 2013.



The network equipment industry is unusual in that even though it is characterised by very high R&D intensity (typically 20% of sales), technological leadership is not a sustainable competitive advantage. The reason for this is that all products need to comply with rigorous wireless standards to ensure mobile handsets can work across most networks globally, and the core intellectual property underpinning radios in the equipment is extensively cross-licensed. As a result, the vendors' continuous R&D investments are more about maintaining their ability to compete rather than creating a differentiated product. There are definitely still differences between each vendor's equipment – however the primary competitive advantage is being able to minimise the unit cost of resources invested in R&D (mainly labour costs of engineers).

This background is important when considering what happened in the mid-2000s when the Chinese vendors Huawei and ZTE entered the industry (Fig 18). At the time they serviced only their local market and so did not have the

scale of the other vendors over which to spread their R&D – but they were able to compete aggressively on the back of unit labour costs being half of the other vendors.



Aside from increasing their overall market shares from less than 5% to 30%, **Fig 19** shows that pricing across the industry fell by a drastic 60% within two years of the Chinese vendors' entrance – which is what spurred the latest round of consolidation across Alcatel/Lucent, Nokia/Siemens, Ericsson/Nortel and Nokia/Motorola.

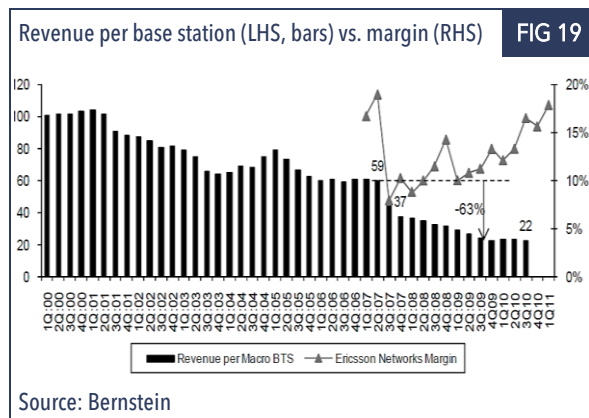


Fig 19 also shows that pricing has stabilised since its initial plunge. There are a few considerations here: firstly, that consolidation has helped ease competitive pressures. Secondly, although Huawei/ZTE have managed to grow their combined global market share to 30%, there are political sensitivities around using Chinese equipment for such critical infrastructure which places a natural ceiling on what share of business they can win. Due to espionage concerns (some of which have been founded) they have almost no business in the US, one of the largest markets globally; political relations between China and Japan have always been sensitive so they hold low share in this large market; and governments primarily in developed countries have been hesitant in awarding them key contracts, with one

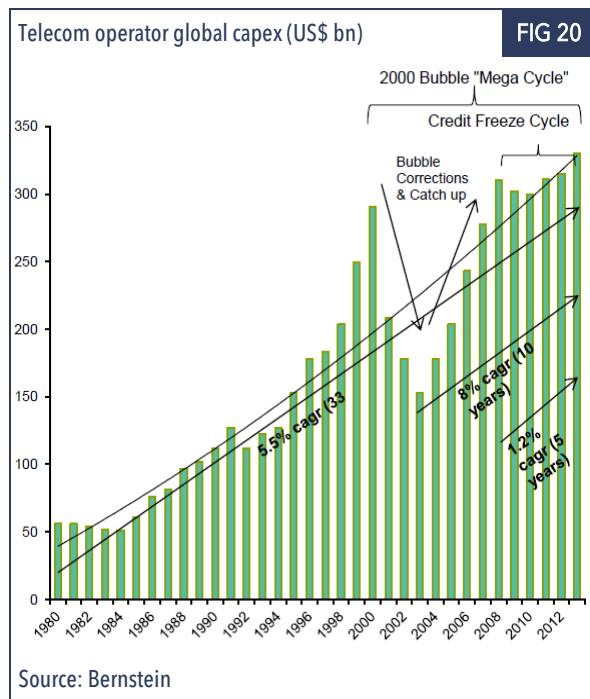
example closer to home being that Huawei was banned by the Australian government from participating in the NBN build-out over security concerns. Finally, executives of both Huawei and ZTE have publically stated that their strategy going forward will be focussed on stabilising margins as opposed to gaining share. As we have seen China's labour market tighten, they have lost some of their initial labour cost advantage and will rely on this margin stability to uphold profits.

One positive aspect of the network equipment industry is that the competitive environment looks like it can only improve from here. As mentioned, the Chinese vendors have a renewed focus on profitability and are naturally constrained in their market shares. The R&D intensity of the industry serves as a high barrier to entry and there remain few companies with the technical expertise to enter at this point – although there have been whispers of Samsung making an entrance with 5G, adoption of this technology is at least four years away. It is also very costly for a wireless carrier to change equipment vendors as this involves a physical replacement of base stations and radio heads at every one of their towers – and given the largely commoditised product, aside from pricing there is very little incentive to do so. Customers are therefore generally quite 'sticky' and the only real churn events are upon moving to a new technology where new hardware will be needed anyway; but currently most of the developed world has completed their 4G rollout, and 5G is in its infancy.

The bottom line is: historically this has been an intensely competitive industry, however waves of consolidation and a stable operating environment for wireless carriers have created a benign competitive environment not seen since the 1990s.

Industry structure aside, one of the primary drivers of both Nokia and Ericsson's recent underperformance has been the belief that spending on wireless equipment has peaked. We do not disagree with this sentiment: the shift from 3G to 4G was very capital intensive for the wireless carriers who had to invest not only in new radio equipment but also more towers in general as the faster 4G speeds drove data usage higher. There have been some sizeable capex programs including Vodafone's \$11bn 'Project Spring' network rejuvenation plan and the Chinese carriers' extensive 4G rollout that are now concluding. Most other carriers in developed markets have already completed their 4G implementation, so the only network build-out that remains is emerging markets who are yet to transition to 4G (or even 3G in some cases) such as India, and eventual investments in 5G which is still some years away. **Fig 20** shows that global

telecom capex is at a record high, and we expect this to decline at 3-4% over the next two years. Over time the proportion of wireless equipment to total capex spend has actually declined from above 40% to currently be at 30%, which we expect to revert slightly so wireless equipment spend only declines 2% a year for the next two years. However, this has been expected for some time and is one of the reasons Nokia's share price has fallen by one-third from its recent peak – to the extent that it currently implies revenue declining at 3% into perpetuity.



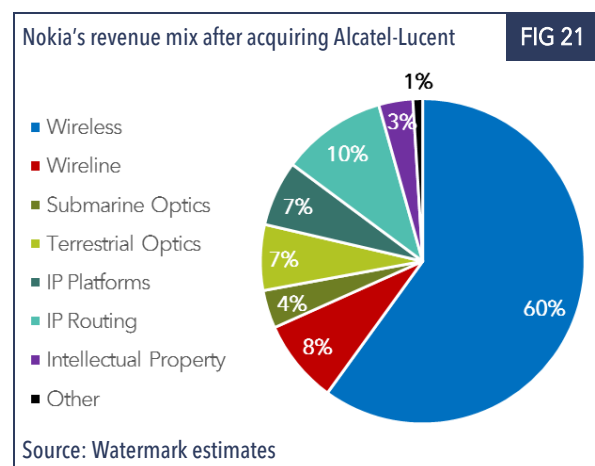
Why buy Nokia now?

As a starting point, we believe the market is being overly pessimistic around its industry outlook. We have for the first time seen signs of pricing stabilisation and easing competitive pressures, there will be no major churn event for the next few years until 5G, which is likely to see profitability improve with no incentive to target market share gains, and importantly the stocks are already pricing in revenue declines due to falling wireless capex spend. Our strong understanding of sectors in our domestic universe (in this instance wireless carriers and their capex intentions) has been the catalyst for study of adjacent industries such as the equipment vendors that supply these carriers, and the basis for investment thesis in Nokia.

Another central aspect to our investment case is that in April last year Nokia announced the acquisition of Alcatel-Lucent, and we believe this deal can unlock significant value. We have spent most of this piece discussing the wireless

industry, the reason for this being that it comprises almost the entirety of Nokia's business and is where most of the synergies lie with Alcatel-Lucent. The sales breakdown of the combined business is shown in **Fig 21**, where Wireless remains the dominant segment. The market greeted this deal with great scepticism – and rightly so given their experiences with this industry in the past. However we believe this deal is different for a few key reasons:

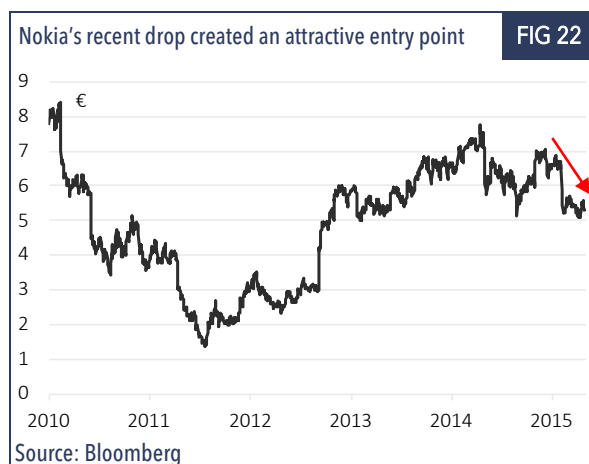
- Prior deals were a distressed reaction to disruptive new entrants, which is not the case this time around since the market has stabilised.
- In prior mergers there were significant cultural clashes (anecdotally for instance it took Alcatel-Lucent two years to debate where the headquarters would lie), whereas this is a clear takeover of Alcatel-Lucent with clear ownership by Nokia, and a clearly-defined executive structure which integrates the Wireless businesses to be led by Nokia and largely leaves managerial control of Alcatel-Lucent's other profitable divisions alone.
- The companies' technologies will be easier to integrate: whereas a decade ago most hardware was specifically designed for each generation and many features were hard-wired, currently most of the features are software-based and common hardware can be shared across multiple generations (2G/3G/4G sitting on the same radio equipment).
- As 4G is an all-IP network, and carriers are focussed on offering more converged products across wireless and fixed services, Nokia will be able to benefit from Alcatel-Lucent's breadth of products including strengths in IP routing and fixed networks to offer more complete products to carriers.



Nokia's venture with Siemens serves as a good precedent for what can be achieved with this deal. Initially cultural clashes were an impediment to integrating the two companies, however in 2013 after Nokia bought out the

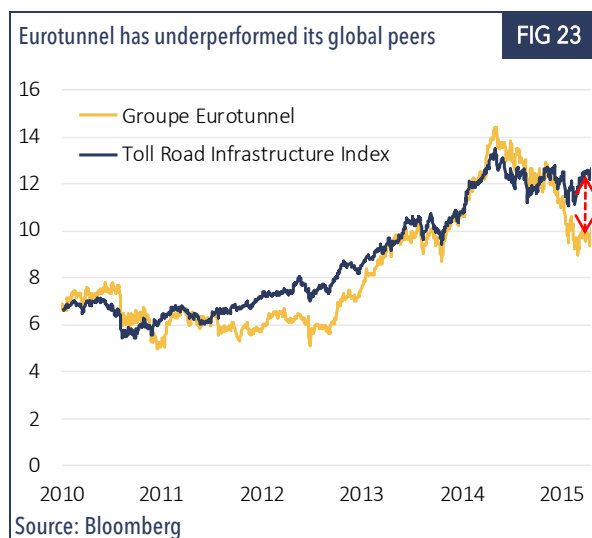
entire joint venture, appointed a new executive chairman and brought in consultants for advisory, the company was able to reduce its operating costs by a phenomenal 40% even in a tough operating environment. Nokia's management currently comprises of this same team who have proven that they can extract value in the past. Currently Nokia have guided for €900mn/yr of operating cost synergies to be achieved by 2018 (and they have already beaten this target by bringing it forward a year) as well as financing benefits of €200mn/yr. We believe the opportunity is even greater given that the combined wireless R&D budget for the two companies is €3bn, and Alcatel-Lucent's unit labour costs are already 15% higher than Nokia's. We also take comfort in the fact that the competitive environment has eased so Nokia is less likely to lose market share during what can be a tough transitional period. Ericsson is undergoing its own internal restructuring after a series of disappointing financial results, while the Chinese vendors are no longer targeting market share gains and are refocussing their efforts on their mobile handset divisions.

A large 15% drop in the share price occurred in February when the company announced a patent settlement deal with Samsung that did not meet the market's high expectations, which presented us with an attractive entry point (Fig 22). Our valuation yields 25% upside from the current price, and this is only assuming that the company meets its guided synergy targets with minimal growth in sales during this period. We believe there is further upside from here if Nokia are able to deliver to the same extent as they did with Siemens, and as industry profitability improves.



Eurotunnel: Quality infrastructure at a discount

Globally infrastructure assets have outperformed since the GFC, as their high yields and defensive growth characteristics have been sought after in a low-inflation and low-growth environment. Our core long investment in Transurban has performed well for these reasons, as management have continued to engage in value-accretive transactions and toll road revenues grow strongly. However, a key consideration with our foray into international markets has been the limited opportunities present in the Australian market. Infrastructure exemplifies this, being a well-known and well-owned sector within Australia given the limited universe of four companies. Domestically for infrastructure it would therefore be rare to come across opportunities like our recent investment in Groupe Eurotunnel, which we identified as a privileged asset for which the market is currently pricing in a worst possible outcome under unlikely macroeconomic scenarios and hence is trading at a 20% discount to its peers (Fig 23).



Eurotunnel is the holder of a 99-year concession (expiring 2086) to operate the rail tunnel between England and France. There are actually two tunnels, one in either direction, as well as a safety tunnel in between. The company has an obligation to run shuttles that carry trucks and passenger cars through the tunnel, and also collects tolls from other trains that pass through (e.g. the Eurostar passenger trains) as well as running a rail operation itself.

The rail business is the easier of the two to evaluate, comprising half of revenues and around 35% of earnings.

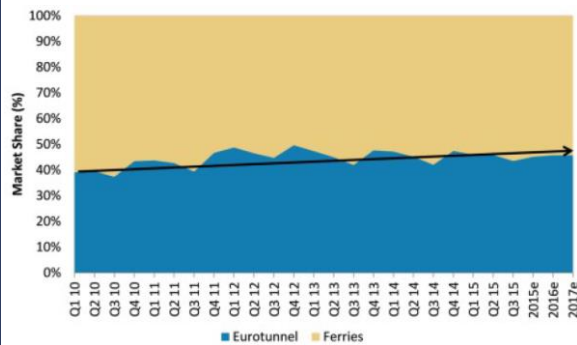
Rail operators have a right to 50% capacity of the tunnel, and have an agreed pricing mechanism until 2052. The two main users are Eurostar's passenger trains (75% of revenues) and other freight operators, who pay both a fixed tolling charge and a per-passenger or per-train variable charge. Eurotunnel also bought two freight operators in distressed sales whose earnings comprise the Europorte segment.

Eurotunnel also has an obligation to run continual truck and car shuttle services, but is free to set its own pricing and commercial terms. They operate 15 truck shuttles at 10-minute intervals during peak periods, and 9 passenger shuttles that run separately. Truck volumes are mainly a function of GDP growth in the UK and Europe (predominantly a UK skew) while passenger volumes mainly originate in the UK so are linked to UK leisure expenditure. Shuttles make up half of the company's sales but 65% of earnings.

The only meaningful competition faced by the company is the ferry operators across the Channel, with limited addressable market overlap to air travel. Historically the ferry operators have priced aggressively which negatively impacted Eurotunnel. The industry has consolidated from five ferry operators a decade ago to two today. As a result both operators have been putting up prices recently for the first time in many years. It's worth noting that typically one-third of the traffic across the Channel will need to use the tunnel either because of time sensitivity or the perishable nature of the goods; one-third will only use the ferries, for instance with flammable goods that can't pass through the tunnel; and the remainder are where the competition lies. Eurotunnel's pricing is generally 30% higher than the ferries, but in return offers a crossing time of 35mins and a fast loading/unloading compared to the ferries' fastest crossing time being 90mins in addition to bad weather which can add hours to the travel time. Additionally Eurotunnel's shuttles carry a per-car charge whereas the ferries charge per passenger and then again for a vehicle - so for two or more passengers (e.g. a family holiday) use of the tunnel might actually be cheaper. Eurotunnel's share of truck passage across the channel fell from 40% in the early 2000s to as low as 30% during the GFC, but has recovered back to nearly 40%. We believe it is likely that management will be able to achieve their target of lifting trucks share above 40%, but do not factor this into our forecasts (Fig 24).

Eurotunnel's cross-channel share continues to grow

FIG 24



Source: Morgan Stanley

The outlook for shuttles is improving: in fact Eurotunnel were facing capacity issues in 2014 where trucks couldn't be unloaded fast enough, and so the check-in/out terminals went through a complete upgrade. The company believes that with a rational ferry market they can regain further share, and have ordered additional shuttles as currently movements through the tunnel still reach 100% capacity during the peak. Historically, price rises (above-inflation is the target) are put through once a year, however recently the company introduced dynamic pricing during peak days (currently 40 a year but targeting an increase in this over time) where they charge a premium. New high-speed passenger rail services are also being introduced across Europe, which is benefitting the tunnel both from higher Eurostar patronage and greater use of passenger shuttles with connecting services to rail at either end of the tunnel.

So what's the catch?

We would be inclined to say that just as the ferry operators rationalised their pricing and things were looking up, Eurotunnel has had a very unlucky year.

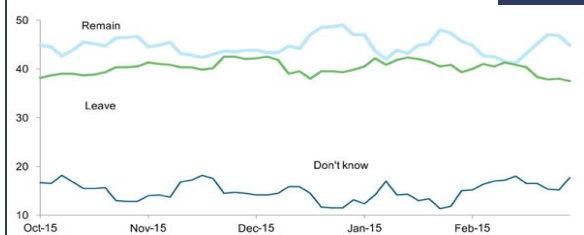
- In January last year, one of the trucks going through the tunnel caught fire which caused disruptions for an entire day.
- In July last year, at the height of the European migrant crisis, there were a number of incidents with migrants climbing over the fence surrounding the tunnel in an attempt to pass through to the UK. One migrant was run over by a train and the crisis culminated in thousands of migrants breaching the fence at the same time. Services were disrupted for an extended period of time.
- Bombings in Paris last year and Brussels earlier this year, together with general security concerns around the migrant issue, saw a sharp decline in leisure travel across Europe.

Since then operations have recovered. Eurotunnel recently reported quarterly results which saw traffic up 10% from the prior year. Unfortunately, a more pressing issue has weighed on the stock which has not allowed it to recover from these past incidents: the threat of 'Brexit' or the UK's exit from the European Union, for which a referendum will be held on June 23rd. The Eurotunnel is (rightly) seen as the physical link between the UK and Europe and so is being treated by the market as a proxy for 'Brexit' occurring. We believe this has been overplayed however.

As a starting point, we see Brexit as an unlikely occurrence. Polls are all indicating support for staying in the EU (Fig 25), prior referendums such as that for Scottish independence where sentiment was even stronger were ultimately unsuccessful and the UK/EU are each other's largest trading partners - it would be an economically difficult process to break this link. Even if Brexit were to occur, there is an official two-year (minimum) legislative process this must occur over, and even then it is inevitable that trade agreements will be signed as they have with other non-EU members. Given that most trucks travelling through the Eurotunnel carry time-sensitive or critical goods, in any event we would expect the impact on Eurotunnel to be even less than any potential decrease in overall trade volumes between the UK and EU. Furthermore, there would be no expected impact to passenger volumes as the UK is not part of the Schengen (the EU's borderless zone) and so there are already border controls and passport checks in place for travelling through the tunnel - there would be no change from the status quo.

'Remain' vote has always led Brexit polls (%)

FIG 25



Source: What UK Thinks

The only legitimate concern we see is the currency impact if the pound were to devalue: revenues are roughly 50/50 euro/pound denominated and Eurotunnel's debt is also 50/50 euro/pound, however its operating expenses are two-thirds in euro. A 10% devaluation of the pound for instance would therefore decrease earnings by 6%. However, the asset has 70 years remaining in its concession and any such temporary correction would make an excellent long-term buying opportunity.

Another concern is the ongoing migrant crisis across Europe, and whether there may be further impacts on either volumes or operations. As part of the treaty that governed the construction of the tunnel, the governments on either end are actually responsible for border security. Following the disruptions last year, numerous layers of climb-proof fencing were installed and a 24/7 French security force was installed. Since then there have been no disruptions, and the upcoming summer will be the best test of this. The multiple terrorist attacks (including one airport) and migrant situation have understandably impacted on leisure travel – but we believe this is actually going to structurally benefit the tunnel. UK tourism statistics have shown a recent preference for shorter-haul closer-to-home holidays which are largely car-based – for instance a family car trip to southern France as opposed to flying to perceptively less stable Greece. Furthermore the migrant situation at the Port of Calais has become dire, with people less inclined to take the ferry due to safety concerns and strikes hitting the port as workers feel unprotected. Given the high security currently in place at Eurotunnel, no doubt its recent market share gains over the ferries have been at least in part driven by perceived peace of mind.

We have been presented with the opportunity to own an incredibly privileged asset with possibly the longest concession life of any listed infrastructure asset in the world, over macroeconomic concerns which are not only temporary but we believe are being overplayed. With nearly 30% upside to our valuation from the current share price which assumes that their shuttle market share remains constant into perpetuity (despite management's stated target to lift this further) and no margin improvement that could be seen from better pricing or cost control, we see this as a core long position in our international portfolio.

Performance Review

The March quarter presented a myriad of challenges for hedge funds globally, wrong-footing many funds as market sentiment vacillated over the period. There were two clear themes around which investors positioned their portfolios in 2015 – a bear market for mining and energy shares and a preparedness to pay up for earnings growth, against a lethargic economic backdrop. These themes have had dramatic reversals in recent months, due in part to intervention from central banks and as a consequence of the value that has emerged in parts of the share market. With the performance of Watermark funds driven principally by individual stock selection rather than thematic tilts, we have been largely insulated from these thematic changes.

Performance was benign in the quarter, with all Funds posting modest falls of around 1%, while the All Ordinaries Accumulation Index fell by 2.4%. The short portfolios made the greater contribution, with notable gains in healthcare, media and bank shares. All funds were net short the market by the end of the quarter as we suspect the relief rally has run its course. Nevertheless, we have shown in recent months that value can be created through stock selection irrespective of the market's direction.

Investments in the resources sector were the biggest detractor from returns in the period. We maintain that many commodity markets will be oversupplied for some time, with multiple factors impeding the rebalancing that is required between global supply and demand. As such, we had a balanced position in resources during the quarter, recognising the challenges that remain but cognisant of the substantial price falls that have already occurred. Our preference has been to pick winners and losers from within the commodities complex. While this worked well in respect of a long position in lithium producer Orocobre, our

strategy in precious metals was less successful with several short positions moving against the Funds. We have used the recent strength in mining and energy shares to establish a modest short exposure to the sector.

Financial shares also detracted slightly during the quarter, with marked volatility amongst the banking names predating a shift in the portfolio strategy. We have been net short the Australian banks for some time, recognising the deteriorating trends in credit markets and challenges in respect of capital positions. Having fallen precipitously, many of the risks are now reflected in the price of bank shares and as such, we closed out several positions. The prices of Canadian banks however have been surprisingly resilient, despite being exposed to many of the same risks that have impacted banks in other parts of the world. We have used this as an opportunity to establish short positions in a selection of Canadian banks.

Amongst cyclical shares, performance was also mixed. Short positions in two international media names were amongst the strongest contributors in the quarter, while an investment in CSR also performed well. Investments in mining contractors were less successful, with a weak half year result impacting the shares of RCR Tomlinson. We continue to find investment opportunities amongst discretionary retail and technology names and hold net long exposures in both sectors.

Defensive sectors of the market did not fare as well in the quarter, with telecommunications and consumer staples both posting aggregate falls. In the gaming sector the funds did well from positions in Wynn Macau and NYX Gaming, both ideas that emerged in the course of our research into Australian gaming companies competing offshore. A core short in the healthcare sector also performed well.



WATERMARK
FUNDS MANAGEMENT



**AUSTRALIAN
LEADERS
FUND**

Company at a Glance - March 2016

ASX Code	ALF
Fund Size	AU\$370.6m
Fund Strategy	Variable Beta
Shares on Issue	268.5m
Dividend (FY15 Final)	5 cents
Dividend Yield (annualised)	6.9%

Net Tangible Asset (NTA) Backing

	Feb 16	Mar 16
NTA Before Tax	\$1.33	\$1.35
NTA After Tax	\$1.35	\$1.36

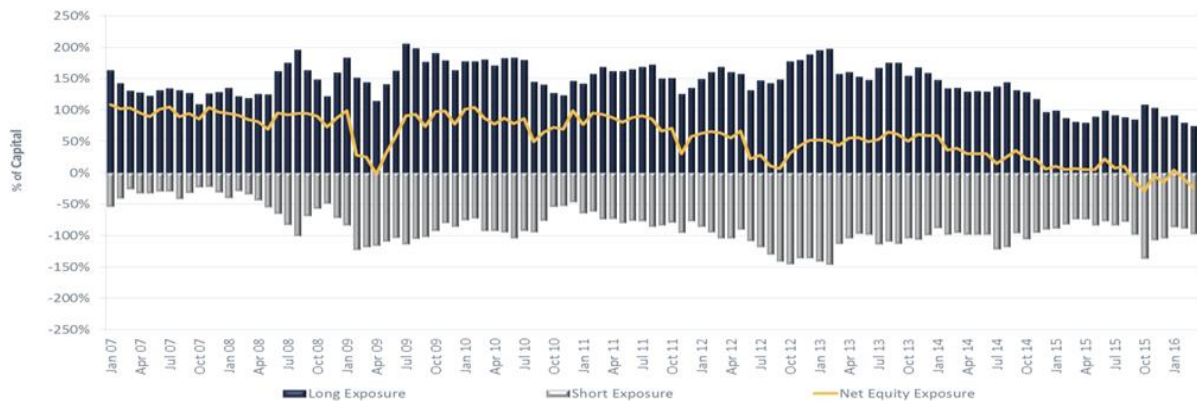
Gross Portfolio Structure

	Feb 16	Mar 16
Long Exposure	80.2%	74.9%
Short Exposure	-89.5%	-98.3%
Gross Exposure	169.7%	173.3%
Cash	109.2%	123.4%

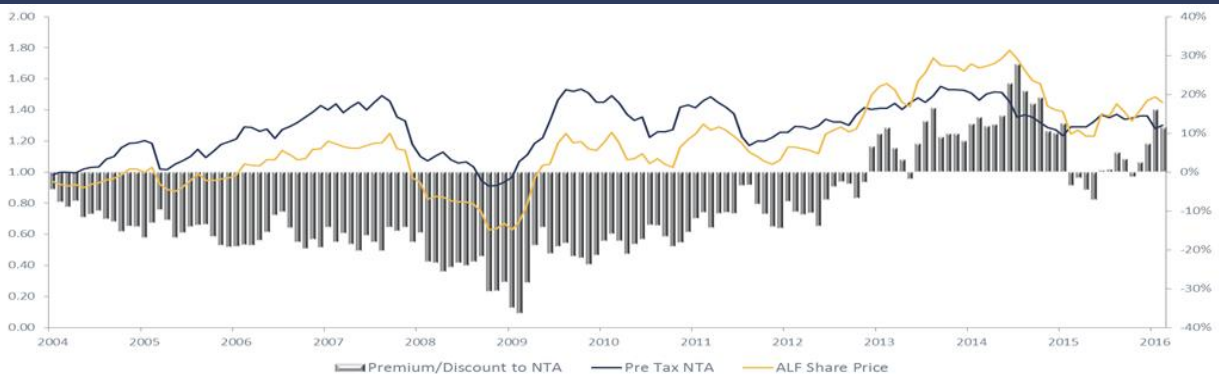
ALF Performance

	1 Mth	6 Mths	1 Yr	3 Yrs (pa)	5 Yrs (pa)	7 yrs (pa)	S.I. (pa)
Portfolio Return (net)	1.4%	0.0%	12.2%	10.4%	10.3%	17.1%	14.0%
All Ords Accum Index	4.7%	4.1%	-8.0%	5.6%	5.4%	10.1%	8.3%
Outperformance (net)	-3.3%	-4.18.8%	20.2%	4.7%	4.9%	7.0%	5.7%

Net Equity Exposure



Historical Premium/Discount to NTA History



Fund at a Glance – March 2016

Fund Size	AU\$47.4m
Strategy FUM	AU\$139m
Fund Inception Date	August 2012
Fund Strategy	Equity Market Neutral
Application/Redemption	Daily
Management Fee	1.5%
Performance Fee	20%
Benchmark	RBA Cash Rate

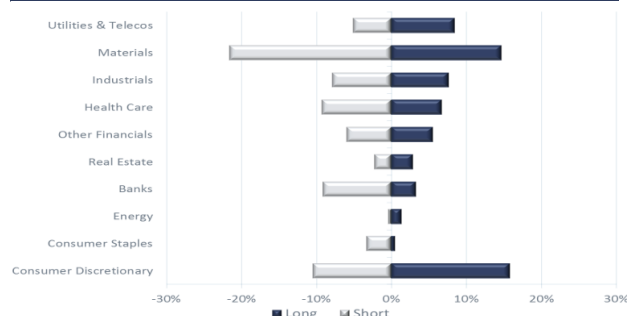
Return Characteristics¹

Positive Months	68.2%
Portfolio Beta	-0.22
Sharpe Ratio	1.6
Sortino Ratio	4.7
Standard Deviation	7.8%
No. Long Positions	46
No. Short Positions	48
Gross Exposure	142.8%

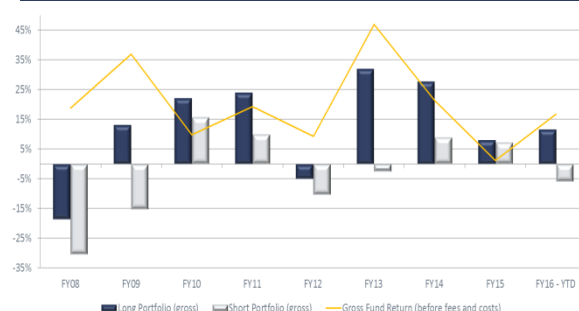
Performance²

	1 Mth	6 Mths	Fin. YTD	1 Yr	2 Yrs (pa)	S.I (pa)
WMNT (net return)	1.1%	2.1%	13.3%	17.5%	8.0%	15.3%
RBA Cash Rate	0.2%	1.0%	1.5%	2.1%	2.3%	3.0%
Outperformance	0.9%	1.1%	11.8%	15.4%	5.7%	12.8%

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	3.82	4.04	2.73	-1.36	1.53	2.93	20.19
2016	-0.14	-1.92	1.13										

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 - March 2016

ASX Code	WMK
Fund Size	AU\$91.6m
Fund Strategy	Equity Market Neutral
Shares on Issue	84.1m
Dividend (1H15)	2.5 cents
Dividend Yield (annualised)	5.7%

Net Tangible Asset (NTA) Backing

	Feb16	Mar 16
NTA Before Tax	\$1.07	\$1.06
NTA After Tax	\$1.06	\$1.07

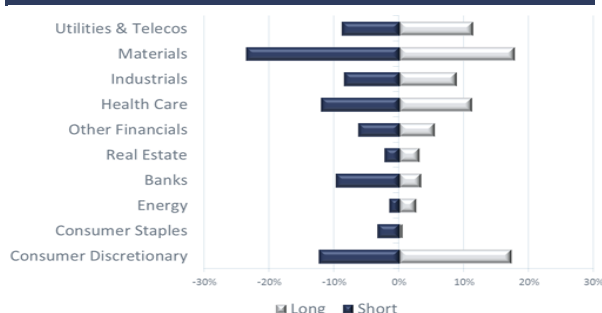
Gross Portfolio Structure

	Feb16	Mar 16
Long Exposure	83.4%	81.3%
Short Exposure	-88.8%	-89.3%
Gross Exposure	172.3%	170.7%
Cash	105.4%	108.0%

WMK Performance

	1 Mth	6 Mths	1 Yr	S.I. (pa)
Portfolio Return (net)	1.2%	1.3%	16.3 %	8.0%
RBA Cash Rate	0.2%	1.0%	2.1%	2.3%
Outperformance (net)	1.0%	0.3%	14.2%	5.7%

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



WATERMARK
FUNDS MANAGEMENT

Level 6, 139 Macquarie Street, Sydney NSW 2000

TEL (02) 9252 0225 • FAX (02) 9252 1220 • info@wffunds.com.au • www.wffunds.com.au