March 2017

BKI INVESTMENT COMPANY LIMITED

BKI Quarterly Report

Reporting Season Wrap Up

Welcome to the latest issue of the BKI Quarterly Report (our 14th). This Report, and previous issues, are available on our website at www.bkilimited.com.au

February Reporting Season Review

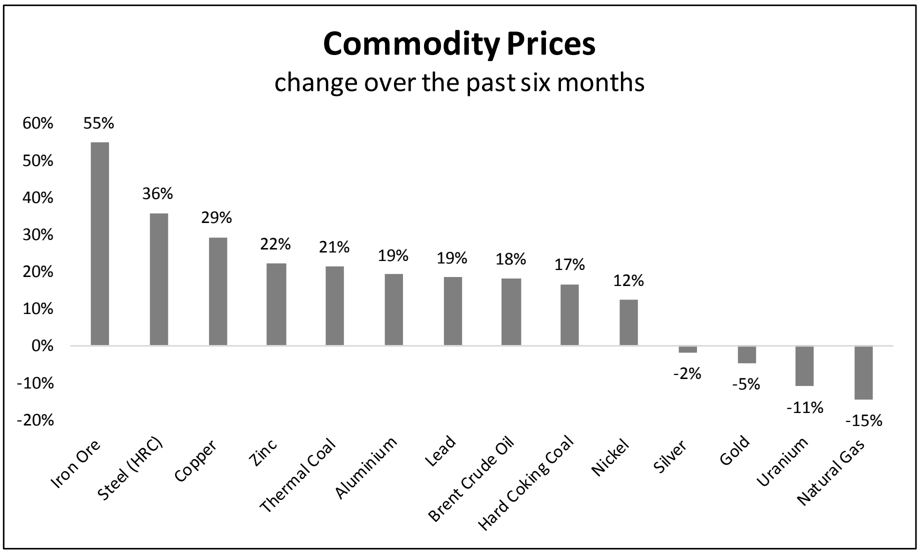
As we often do at this time of the year, we reflect on the latest round of company results. We consider the latest period of company results to be sound. As always, there are some results that disappoint but on the whole, profit numbers beat expectations. Many pundits continually claim that we are in a "low growth environment". While this may be true for many pockets of the Australian economy, we were encouraged by both earnings reported and outlook statements by many companies in the BKI Portfolio.

The Australian market has been remarkably strong over the last twelve months. Many readers will be surprised to hear that the Australian stock market (as measured by the S&P/ASX 300 Accumulation Index) increased by 22% over the year to 28 February 2017. Remember this was a year that we witnessed Brexit, the surprise US election result and crude oil traded below USD$30 per barrel. BKI's performance lagged the market, largely due to an underweight position in the Resources sector. Many resource companies do not pay dividends which makes the investment proposition difficult for us.

What did we takeaway as the key points of the February results season?

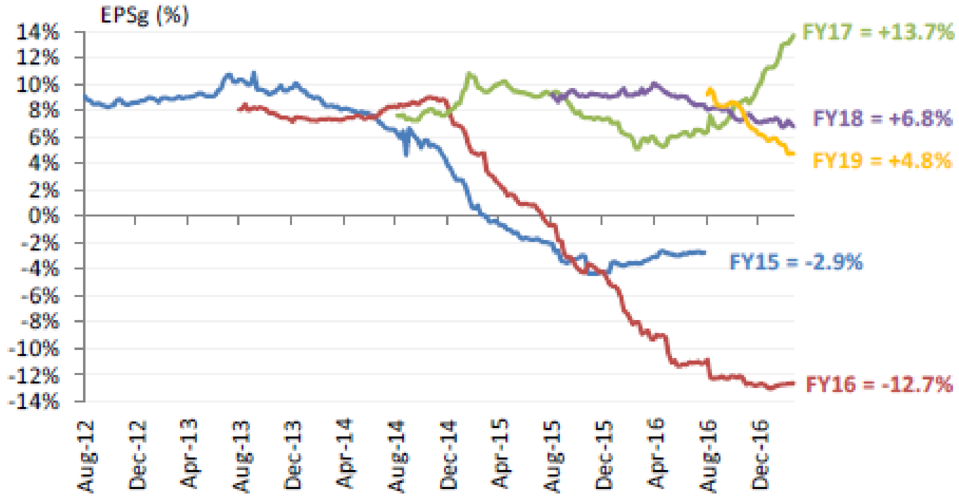
Resources earnings were strong but that didn't necessarily translate into share price strength

The following chart summarises the extent of some moves in major commodities, which extended into strong earnings growth for the major Resource companies.



The rebound in earnings expectations for the Resources sector has been significant and led to a material uptick in earnings expectations for FY17. The following chart suggests that the growth expectations for FY18 and FY19 are also above average. Much of the growth in FY18 and FY19 is expected to be outside the Resources sector. The results season indicated that earnings growth (ex Metals and Mining) is reasonable.

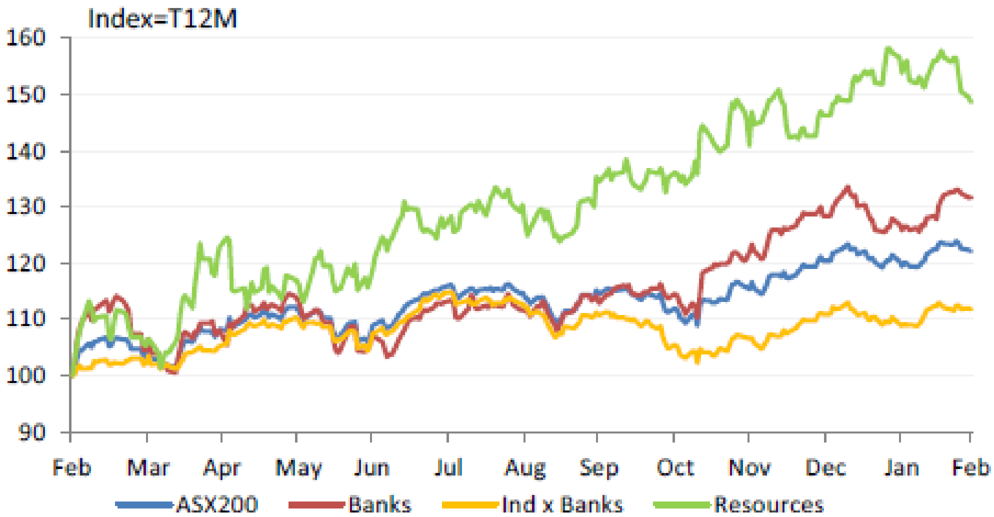
Exhibit 113: Annual Consensus EPSg Trends FY15-19



Source: RIMES, IBES, Morgan Stanley Research

However, even as the Metals and Mining sector reported solid profits and earnings growth in February, share prices were more muted as investors start to consider that maybe markets are approaching a potential peak in commodity prices. It is worth noting in the chart below that the Banking sector has performed well in recent months. It now seems likely that capital requirements under new international banking regulations may be less harsh than many feared. We believed that this would be the case and have held onto our Banking stocks as long term investments within the BKI Portfolio. We didn't get caught up in the short-term noise of trading out for the fear of a shortfall in international capital requirements and the need for banks to raise funds.

Exhibit 41: ASX 200 vs. Industrials ex Banks, Banks and Resources



Source: RIMES, S&P, Factset, Morgan Stanley Research

Other key themes that we took out of Reporting Season included:

- Consumer trends look on the soft side – the consumer remains cautious and continues to be focused on getting on top of the mortgage first and spending money on discretionary items second. The CBA result and subsequent meetings with management again highlighted that the average mortgage holder is approximately 30 months ahead on mortgage repayments. The Australian consumer still seems willing to spend money in restaurants and cafes, but traditional discretionary items such as clothing and footwear remains challenging. We notice with our office based in Pitt Street Mall, Sydney, that the "SALE" signs in retailer windows seems more prevalent than ever.
- As always, those high PE stocks that failed to deliver on earnings growth were treated harshly. Those with decent results (such as SEEK, ARB, Sydney Airports and Transurban in the BKI Portfolio) did well, however those that disappointed, for example Brambles (owned by BKI) or Dominos (not owned by BKI), de-rated heavily.
- Cost cutting remains a feature – for a lot of industrial stocks, it is rising margins rather than sales growth which drove improvements in net profits. We continue to look for those companies that continue to invest in their businesses. Particularly those that can invest at reasonable rates of return.

There were a few disappointing results

- Brambles ("BXB") has been a very disappointing performer in recent months, which has undone years of good operating performance under CEO Tom Gorman. Mr Gorman announced his resignation six months ago and delivered his final result in February. However, the result uncovered a worse than expected result in the US pallet business. There is now a new CEO / CFO team at Brambles which has also meant widespread changes at Senior Management level. The experience at Brambles in recent months reminds us of the importance of Management and that a change in management is a call to action to revaluation of the investment case.

- The Primary Healthcare ("PRY") result was another one which comes soon after a CEO resignation as Peter Gregg will step down in the coming months. The interim FY17 result was characterised by a far weaker than expected performance in the Medical Centres business. In the last couple of years, PRY has been focused on adjusting the remuneration structure of its Doctors. The model has changed to pay less for doctor's acquisition costs (to join the Primary Medical Centre model) but has meant a change in the revenue share model, in favour of the doctor. As this washes through, near term earnings have suffered but the longer term strategy has merit.

- The Telstra result was another one which was weaker than hoped. There is limited growth being delivered by the Group as the legacy fixed line business continues to roll off and the expected margins under the National Broadband Network (NBN) will reduce. We remain comfortable on BKI's holding in Telstra and remain of the view that Free Cash Flow generation will be significant in the coming years as Telstra receives compensation from NBN to migrate customers. TLS will also benefit from payments (which are not insignificant) to maintain the legacy HFC network for NBN. The grossed up dividend yield for Telstra is over 9%, which is expected to support the share price around current levels.

Yet other companies are performing well

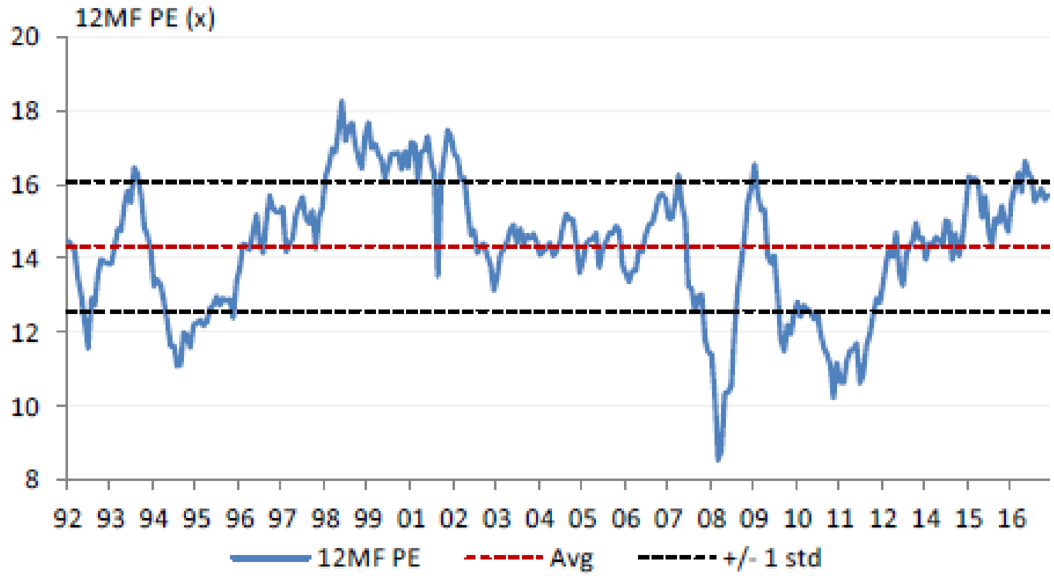
- The Transurban ("TCL") result was impressive yet again. This business is well managed and has excellent operating momentum. Over the last six months, the market sold TCL down from $11.60 to a low of $9.60 in November 2016, over concerns that movements in long bonds will put pressure on yield stocks with gearing. While we remain alert for macroeconomic changes and the impact it has on the BKI Portfolio, we are also bottom-up stock pickers and often look into the detail. On that, we note that despite extensive focus on bond yields, Transurban managed to extend the maturity of its borrowings and reduce the cost of debt. Since November the stock has rallied back to close last week at $11.39. Rising inflation is not all bad news for TCL. Toll road prices are linked to inflation – if CPI increases, so do the tolls that TCL charges road users.

- As noted above, SEEK delivered another strong result. The company was criticised by many broking analysts two years ago for investing in the business at a time when most companies were focused on cost out. The strategy to invest in growth was rewarded in this latest result which delivered strong returns domestically and in many international operations, notably China.
- Elsewhere, Coca-Cola Amatil delivered a solid result which was ahead of expectations and highlighted the strength of offshore growth markets. CEO Alison Watkins has been delivering on a sensible strategy over the past two years which is intended to offset declines in traditional markets and products.

Market Valuations

- The improved outlook for earnings growth was much needed in a market that is not cheap by historical standards. However, with term deposit rates at generational lows, there is little incentive to transition into cash. We will remain alert for opportunities in the Australian market. BKI is close to fully invested. We continue to take the view that BKI shareholders invest in the company for exposure to an Australian Equities Portfolio, not for BKI to manage an investor's cash position.

Exhibit 79: ASX 200 - Latest: 15.7x

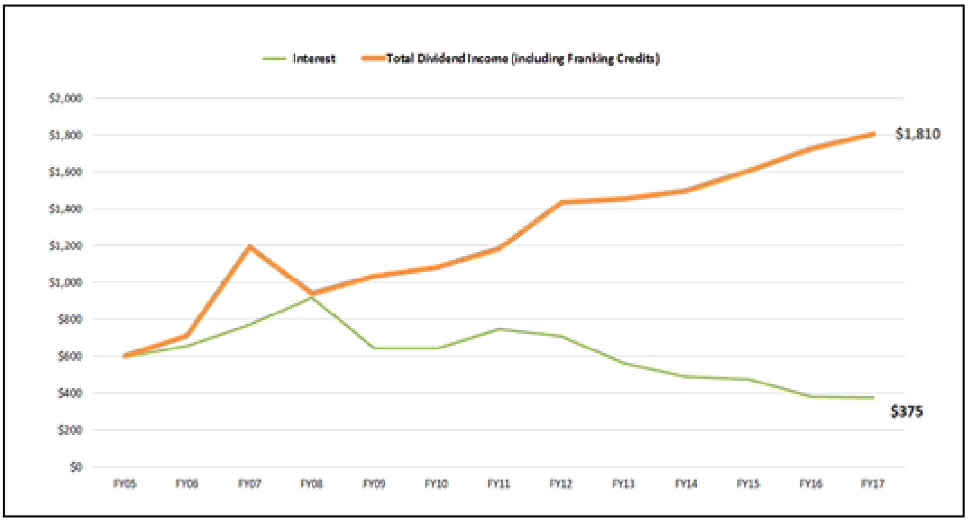


Source: RIMES, IBES, Morgan Stanley Research

BKI Dividend Yield

The dividend yield for the market remains attractive. Our goal at BKI is to build a diversified portfolio of quality companies that generates a balance of dividend yield and growth. The chart on the following page has been discussed numerous times—BKI's dividend history is something we are very proud of. It shows Dividends and Franking Credits received from a $10,000 investment in BKI at inception versus Bank Quarterly Interest. An investor who spent the equivalent of $10,000 to purchase BKI shares upon listing in December 2003 would now be receiving fully franked dividends of $1,267pa. The franking credits enhance the income by a further $543, assuming a tax rate of 30% (total income of $1,810). The same investment in a term deposit (based on the cash rate + 0.50%) would be earning $375pa with no franking credits. Figures include reinvestment of dividends and cash and ignores capital appreciation of BKI shares.

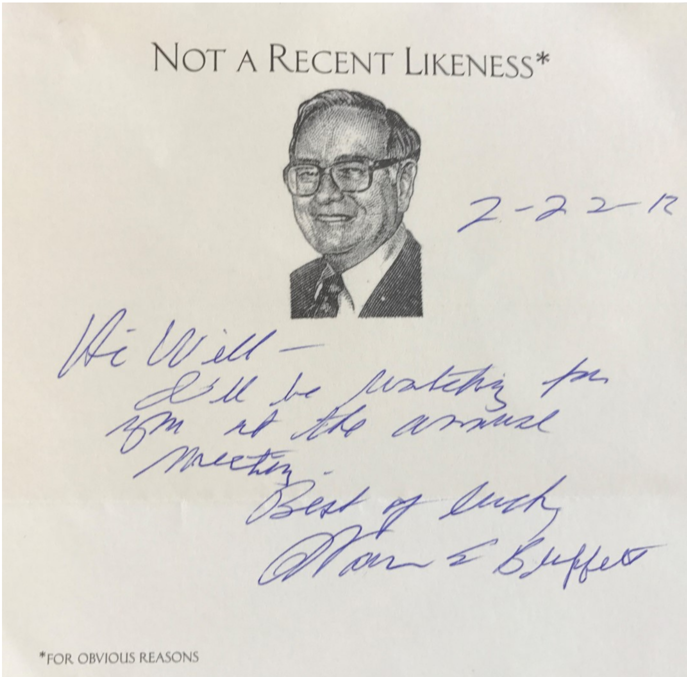
The chart below shows Dividends and Franking Credits received from a $10,000 investment in BKI at inception versus Bank Quarterly Interest.



Welcome Letter from Warren Buffett

As regular readers would be aware, we are close followers of Warren Buffett and Berkshire Hathaway. In May this year, we will again make the annual pilgrimage to Omaha, Nebraska to attend the Berkshire Hathaway Annual Meeting. We gain great insights from this trip, not just from the Meeting itself but from engaging in discussions with the management teams of several of the Berkshire associates. We find we gain a tremendous insight into the pulse of the US economy by discussing business conditions with executives from Brooks Running, Clayton Homes, Coca-Cola, Wells Fargo and Nebraska Furniture Mart. We look forward to updating BKI shareholders on our key learnings from the trip.

In the meantime, we were thrilled when Will Culbert received a letter from Warren Buffett recently as pictured on the right.



Tom Millner and Will Culbert
Contact Asset Management

27 March 2017