Platinum European Fund

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Disposition of Assets

REGION	DEC 2012	SEP 2012
Germany	40%	42%
UK	18%	16%
France	13%	16%
Spain	3%	3%
Italy	3%	4%
US *	2%	2%
Sweden	1%	2%
Netherlands	1%	2%
Belgium	1%	1%
Russia	1%	1%
Cash	17%	11%
Shorts	9%	8%

* Pulp stock listed in the US but predominant business is conducted in Europe

Source: Platinum

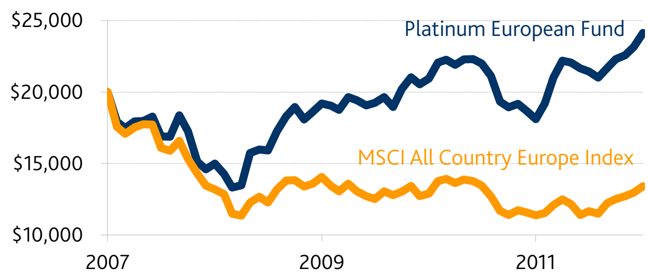
Performance

We left off last quarter with the observation that the large rebound in European stock markets was not a cause for concern, as the fears that had left many investors with the view that Europe was 'un-investable' were only just starting to fade. This process of investors becoming more positive on the outlook has continued over the last three months with foreign investors in particular returning to Europe. In the face of this, all the major stock market indices were up, with the French +10%, Italian +8%, German +5% and the UK and Spanish both +4%.

With a view to individual stocks, in general the markets strength was quite broad. Out of Europe's largest 300 companies, 75% rose during the quarter, whilst only 18 stocks fell more than -10%. The standout performers by sector included the Luxury Goods companies (Prada +26%, Burberry +22%, PPR +17%, Hugo Boss +16%) which did well on the back of better than expected sales in China, whilst the Aerospace Engineers (EADS +19%, Safran +16%, Zodiac Aerospace +10%) continue to enjoy record demand for new commercial passenger aircraft. Those 18 stocks that did have falls greater than -10%, were largely clustered in the Electric Utilities (E.On – 23%, EDF -15%, GDF Suez -12%), Telecoms (KPN -38%, France Telecom -12%, Telecom Italia -12%) and Oil Services sectors (Saipem -21%, Fugro -16%).

Value of $20,000 Invested Over Five Years

31 December 2007 to 31 December 2012



Source: Platinum and MSCI. Refer to Note 2, page 5.

Measured in Australian dollars, the European Fund was up 8.3% over the quarter versus the MSCI All Country Europe Index up 7.2%. Over the last calendar year, the European Fund has returned 33.3%, beating the Index by a full 15.4% (the Index returning 17.9%).

Commentary

When the Fund takes a substantial new holding in a company, we aim to include a detailed write-up in the quarterly outlining the thinking behind the investment. Regular readers may be wondering how those cases have been playing out, and hence we are going to use this quarterly to look back and review a number of those investments.

To ensure we are focusing on investments that have had enough time to progress, we will look at the ideas presented in the March 2011 and June 2011 quarterlies - giving us three names – Deutsche Börse, Lloyds Bank and Amadeus.

Deutsche Börse (world leading German exchange organisation) - a case that has not played out as expected.

Initial Case

Our case on Deutsche Börse (DB) presented in March 2011 was built around the view that:

1. The regulatory threat of having their monopoly position in derivatives trading opened up to competition would end up being toothless.
2. The other side of the regulatory coin was that DB was set to benefit from additional clearing revenues, as regulators were forcing “over the counter” (OTC) derivatives to be electronically traded and cleared from 2013.
3. Trading volumes in that same derivatives business would continue to grow, albeit much slower than in the past. DB’s derivatives business had seen trading volume fall by 25% from peak levels post the GFC. Whilst the days of this being a 20% grower were over, we thought they could still grow at mid-to-high single digits from this low base going forward.

How the story has progressed

The regulatory side of the story has largely played out as expected. The European market regulator has indefinitely put on hold any prospect of forcing new competition in derivatives trading and while new regulatory threats have emerged in the form of the European Financial Transactions Tax (FTT), the cost of this will likely be more than offset by revenue gains as OTC derivatives come onto exchange in 2013.

Where we have been wrong is the presumption of steady growth in derivatives trading volume. Post taking our position in early 2011, the story looked on track as trading volume in both DB’s equity index and interest rate futures continued to grow strongly in the second half of the year, finishing up 19% and 10% respectively on levels seen in 2010. However, 2012 has been a different story. Weak equity markets and a continuation of zero interest rate policies have seen DB’s equity index and interest rate futures volume drop 15% and 23% respectively. Earnings per share for the company have fallen from €4.50 in 2011 to €3.70 in 2012.

Deutsche Börse is now trading at €46 versus our initial acquisition price in the €52-€55 range. Over our holding period we have received €5.40 in dividends, giving us a total return of -10%. A poor performer but not catastrophic.

So what do we do from here? Looking at the drivers of the business, from a cyclical point of view, volumes have bottomed in interest rate derivatives. Trading volumes in equity index futures and cash equities could fall further but it is clear we are far closer to the bottom of the cycle than the top. Deutsche Börse offers an 8% earnings yield, with a management team that is returning the full 8% yield to investors (we receive 5% via dividend and 3% via share buybacks). Given the current 8% earnings yield is based on what are fairly depressed earnings, there is enough upside to continue to hold.

Lloyds Bank (UK financial) – the case is progressing as planned but it would have been nice to get the timing perfect!

Initial Case

When we wrote about Lloyds in June 2011, the market was primarily concerned that the bank:

1. Would be required to raise additional capital.
2. Had a high reliance on wholesale funding (Lloyds had a loan to deposit ratio of 160%), which would pressure profits as the cost of wholesale borrowing was rising.

On these issues we were less concerned. In respect to the need to raise capital, we concentrated on the fact that the company had already written off £70 billion of its loan book and was making pre-provision profits of £12 billion pa. This meant that Lloyds had likely already seen the worst of the credit costs from borrowers defaulting on their loans and had the ability to generate a lot of new capital each year through its profit base.

We agreed that the higher cost of wholesale funding would squeeze profits. But there were a number of reasons why the outcome might be better than feared, namely:

1. The UK banking market had consolidated massively post the GFC and they were now the largest player with 30% market share. In addition, their competitors had a heavy reliance on wholesale funding as well. All of this meant it was more likely that some of the increased cost would be passed onto customers.
2. Lloyds was aggressively shrinking its "non-core" loan book (a collection of overseas and local large scale commercial loans). As this shrunk so too would the bank's need for outside wholesale funding.
3. With a combined workforce of 110,000 post their merger with HBOS, Lloyds had a lot of scope for cost cutting now that they were shrinking in size. Lloyds new CEO Antonio Horta-Osorio had performed similar cost cuts at competitor Santander UK and was doing the same at Lloyds.

How the story has progressed

From an operational standpoint Lloyds has done well and management have done exactly what they said they would do. From 2010 to today, the deposit base has grown from £394 billion to £423 billion, whilst the non-core loans has fallen from £195 billion to £118 billion, with the loan to deposit ratio now at 120%, down from 160%.

The higher cost of wholesale funding has hit profits, with the net interest margin (the difference between the interest the bank earns from its loans and has to pay for its funds or deposits) falling from 2.21% to 1.93%. This has been somewhat offset by lower costs, with operating expenses falling from £13.1 billion to £10.1 billion. The bank has continued to build capital via its profit retentions and did not need to raise extra funds through a share issue as feared.

This steady operational progress was masked by some truly incredible swings in Lloyds share price. The last 18 months has been a great lesson on the irrationality of the share market when it is panicked by fear.

We started building our stake in Lloyds in late June 2011 at a price of 44 pence. At that point the stock had recently fallen 37% from its previous trading range of 70 pence and offered a valuation of 0.7x P/B and a 6x P/E of what it could earn a few years out – good value we thought. However, shortly after, the share price of Lloyds went on a wild roller-coaster ride, with the price eventually bottoming five months later at 22 pence, a further 50% fall!

The main reason for this collapse was simply the panic over the European sovereign crisis which peaked in November 2011. Whilst the stock prices of the whole European banking market saw heavy falls, despite almost no direct Euro zone exposure, puzzlingly Lloyds was one of the worst performers. At the bottom, Lloyds was valued at 0.3x P/B and 3x P/E, even the Spanish banks never got that cheap!

We continued to add to our position as the stock kept falling and at a current price of 50 pence, Lloyds has been one of the best performing stocks for the Fund in 2012.

Amadeus (global travel distribution system) – it has been a smooth flight.

Initial Case

When we made our initial investment in Amadeus it was a classic example of a stock that was not really on investor's radar screens. Our investment case was very simple. Amadeus was an extremely high quality business that offered predictable sales and profit growth but was priced like a no-hoper on 11x P/E.

The driver of the growth was two-fold. Firstly, Amadeus's air ticket Global Distribution System (GDS) business by virtue of its leading position in every market outside of the US would continue to tick along at a 5% growth rate driven by growing demand for air travel in Asia, Latin America and the Middle East. Their second business, the Altea software suite, was going through a huge growth phase. Altea allows airlines to outsource their critical IT functions around ticketing, inventory control and departure management to Amadeus. Demand for IT system outsourcing was booming, driven by the IT complexity of air-travel[1] and Amadeus had already signed up 110 of the world's leading airlines to shift to their system.

How the story has progressed

So far the revenue and profit growth at Amadeus's two businesses has been very much to plan. As advertised, the GDS business is growing at 6%, fuelled by the growth in air-travel bookings in the emerging markets. The Altea airline software business has been very strong; revenue and profits are growing at 15% as the new airlines progressively migrate onto their system. Cathay Pacific, Scandinavian and Singapore Air have made the shift to Altea in 2012 and the company has signed up another 12 airlines to use the Altea software, taking the total number of airlines contracted up to 122.

The significant new news is the inroads Amadeus is making expanding its business in the US. The US remains the largest single travel market in the world but for historical reasons, Amadeus has had little business in the US, with the market being dominated by Sabre and Travelport. But there are signs this is changing, with a number of recent milestones:

1. Southwest Airlines, the largest US domestic carrier signed up to use the Altea software for its international flight bookings, with the expectation that in time Southwest will also shift its US flights onto Altea. This is a major prize, as despite providing IT for global giants like British Airways and Qantas, Amadeus had yet to sign up any of the major US carriers.

2. Expedia, the largest US online travel agent, have agreed to use Amadeus to process their US air ticket bookings. Previously Expedia had used Sabre exclusively in the US.

3. Kayak, the world's largest air travel search and price comparison website, announced that Amadeus will now provide the data feeds to power their website in the US. Amadeus is now Kayak's main source for pricing and flight data on a global basis.

Overall, the prospects for Amadeus continue to look promising. The stock has performed well, with the price up roughly 40% from our average entry point. Amadeus is now trading on a valuation of 14x P/E, still relatively modest compared to similar businesses in the service sector and we are happy to hold as the company continues to grow.

Outlook

While European markets are not particularly over-valued there are a few reasons to be cautious in the near term. Firstly, we are coming off a very strong run, the leader being Germany with its market up 29% year to date. Secondly, the recent enthusiasm of investors to chase the "laggards" (where investors are buying companies not based on the underlying fundamentals of the business but because those stocks have yet to "go up") tends to signal we could be due for a short-term pull-back.

On that basis we have been gradually selling down some of our better performing holdings where the story has played out and holding higher cash levels. At the time of writing, the Fund is 83% gross invested, with 17% in cash and 9% in shorts, giving a net invested position of 74%.

[1] Think about the new system demands that have been introduced around code sharing with airline alliances, frequent flyer points and charging for ancillary services like checked bags when booking a ticket. These new requirements have stretched the capability of the airlines legacy mainframe systems.

Notes

1. The investment returns are calculated using the Fund's unit price and represent the combined income and capital return for the specific period. They are net of fees and costs (excluding the buy-sell spread and any investment performance fee payable), are pre-tax, and assume the reinvestment of distributions. The investment returns shown are historical and no warranty can be given for future performance. You should be aware that historical performance is not a reliable indicator of future performance. Due to the volatility of underlying assets of the Funds and other risk factors associated with investing, investment returns can be negative (particularly in the short-term).

   The inception dates for each Fund are as follows:
   Platinum International Fund: 30 April 1995
   Platinum Unhedged Fund: 31 January 2005
   Platinum Asia Fund: 4 March 2003
   Platinum European Fund: 30 June 1998
   Platinum Japan Fund: 30 June 1998
   Platinum International Brands Fund: 18 May 2000
   Platinum International Health Care Fund: 10 November 2003
   Platinum International Technology Fund: 18 May 2000

2. The investment returns depicted in this graph are cumulative on A$20,000 invested in the relevant Fund over five years from 31 December 2007 to 31 December 2012 relative to their Index (in A$) as per below:
   Platinum International Fund - MSCI All Country World Net Index
   Platinum Unhedged Fund - MSCI All Country World Net Index
   Platinum Asia Fund - MSCI All Country Asia ex Japan Net Index
   Platinum European Fund - MSCI All Country Europe Net Index
   Platinum Japan Fund - MSCI Japan Net Index
   Platinum International Brands Fund - MSCI All Country World Net Index
   Platinum International Health Care Fund - MSCI All Country World Health Care Net Index
   Platinum International Technology Fund - MSCI All Country World Information Technology Net Index
   (nb. the gross MSCI Index was used prior to 31 December 1998 as the net MSCI Index did not exist).

   The investment returns are calculated using the Fund's unit price. They are net of fees and costs (excluding the buy-sell spread and any investment performance fee payable), pre-tax and assume the reinvestment of distributions. It should be noted that Platinum does not invest by reference to the weightings of the Index. Underlying assets are chosen through Platinum's individual stock selection process and as a result holdings will vary considerably to the make-up of the Index. The Index is provided as a reference only.

3. Long invested position represents the exposure of physical holdings and long stock derivatives. The net invested position represents the exposure of physical holdings and both long and short derivatives.

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