

27 January 2012

Mr. & Mrs. Client

Dear Client

Welcome to the 2011/12 half year financial year report. With Australia Day passed, this report is later than usual. The timing has more to do with being away until mid January - faced with the choice of simply reporting the results in a timely fashion or reporting in a more worthwhile manner, I chose the long road (ten pages to be exact). Numbers can tell a story but they don't tell the whole story.

In the first half of the 2011/2012 financial year, being the period 1 July 2011 through 31 December 2011, the market fell 12%. Add market dividends and franking credits, and a portfolio 100% invested in stocks only would have had a negative 9.5% return, a portfolio invested 70% stocks and 30% income securities/cash a negative 5.9% return, and a portfolio invested 50/50, a negative 3.5% return.

Client portfolios invested according to my recommendations, with a 50% allocation to equities and 50% allocation to income securities, suffered losses in line to their benchmark. A portfolio allocated 70% equities and 30% income securities on average suffered a percent or two worse than their benchmark. This was a result of having a higher allocation to equities as they represent similar yields to income securities with better upside. The time to take additional risk (if appropriate) is when the market offers opportunities as compared to when profits are just desired (often at or near market tops). Finally, portfolios 100% invested in equities, on average suffered at market rates, but the variance in individual portfolios was a couple of percent around the average depending on individual situations. In the first half of 2011/12 everybody went backwards.

This letter contains the results for your portfolio(s) for the six months reconciled on a cash basis. Also contained are printouts of end of period balances, trading history, cash transaction history and dividends – being all the reports needed to reproduce the portfolio result. Also, there is an investment objective profile that places each client on one of the above categories and a position summary report (consolidated for multi account clients) with future dividend estimates.

Results for the 1st Half of 2011/12

Cash reconciliation	actual
Closing E*Trade account balance on 31 December 2011	\$ -
less	
Opening E*Trade account balance on 30 June 2011	\$ -
	<hr/>
Change in the account balance	\$ -
<i>less</i> Your contributions made in the period	
cash contributions from dividends debited into E*Trade ANZ CMT	\$ -
<i>add</i> Your withdrawals made during the period	
cash transfer out of E*Trade ANZ CMT	\$ -
	<hr/>
Change in account value	\$ -
<i>add</i>	
dividends and franking credits earned during the period	\$ -
	<hr/>
TOTAL net LOSS for the period	<u>\$ -</u>
% change from the opening balance for the period	

note: interest received and brokerage paid are included in E*Trade account balances

Markets Reviewed

In 'The Wisdom of Crowds: Why the Many Are Smarter than the Few', the author James Surowiecki suggests 'collective decisions are most likely to be good ones when they are made up by people with diverse opinion, reaching individual conclusions relying primarily on their private information'. By way of simple and amusing illustration he tells the story of a weight judging competition at a local fair in which the town folk, local farmers and passersby pay to guess the weight of meat that a currently live ox on display will produce when slaughtered. Despite the diversity of the group's occupations from butchers to clerks, the combined average guess was the most accurate guess of any made.

Financial market prices result from this collective decision making because the market consists of diverse groups with different attitudes toward risk, different time horizons, different investing styles and different information. Surowiecki said "The idea of the wisdom of crowds is not that a group will always give you the right answer but that on average it will consistently come up with a better answer than any individual could provide". (Inversely we can say market bubbles and crashes become classic examples of collective decision making gone wrong because independence, diversity and private judgment disappear.)

The US stock markets are closing in on all time highs and Europe's market has bounced 20% from last year's lows. Yet this is at odds to what I have been reading in the financial press where attitudes towards risk are commonly averse, horizons are all short term, and everyone looks to everyone else to answer the questions on Europe's sovereign debt and common currency crisis. Maybe the collective decisions that form the market are telling us something that isn't obviously observed.

Some of the big economic developments in the last six months include Standard & Poor's downgrading of the US's AAA credit rating to AA+ while maintaining a negative outlook. The irony of this downgrade is the US government can't default on its dollar payments to creditors any more than Hasbro, owners of the board game Monopoly, could default on any debt someone is willing to take in Monopoly money. In other words when you have the ability to print the money in which you make the payments, you don't have a debt crisis, but you could have an inflation problem. In reality it is the owners of the debt that have the problem.

This situation is the inverse facing indebted European nations that share the Euro as a single currency. For example, the Greek government has borrowed money in a currency that it cannot print. When repayments fall due for outstanding interest and debt, the only true access to Euros the Greek government has is through taxes raised or expenditure reduced (alternatively it could do a Jeff Kennett and sell off state assets). In approximate terms the Greek government owes Euro to the equivalent amount of US\$470 billion US dollars, having recently been spending the equivalent of 50% of its US\$310 billion economy, while collecting revenue of only 40%. To put this in context Australia at a Federal and State government level has a similar level of debt at US\$410 billion, but, has an economy six times bigger than Greece's at US\$1,850 billion dollars, and spends/taxes 20% of GDP.

How did it get to this? The rules of the Economic Monetary Union (EMU) which all European Union (EU) nations are supposed to follow (those that use the Euro and those that aspire to use the Euro) place restrictions on member borrowing levels. I have read that Greece was able to hide the extent to which they had borrowed, but as of 2008, government debt to GDP was already 100%. Since then the Greek government has run budget deficits of up to 15% of GDP as government revenues dried up due to the nation's lack of competitiveness, while government expenditure rose as wages exploded (there are a lot of government employees). It doesn't take long for such deficits to compound to the point of government debt to GDP approaching 150%.

Greece's position is untenable. Prior to the introduction of the Euro, the Greek Drachma would have depreciated as the government met interest and debt repayments by printing the Drachma. The holders of Greek government debt would have lost money as the Drachma depreciated, and slowly but surely, Greece's ability to raise debt would have been compromised by having to offer higher interest rates, or lenders would have backed off worried about the currency loss. In other words I doubt the situation would have got to where we are today.

Greece is only one letter in the PIIGS acronym, with Portugal, Ireland, Spain and Italy (Euro debt equivalent of US\$2,600 billion with a US\$2,200 billion economy and 46% of government spending to GDP) all facing the same predicament.

Complicating the situation is the French, German and other European banking sectors holding government debt of the PIIGS. With many banks facing sovereign debt write offs they may require equity at the same time as facing withdrawing of deposits and further bank bond depreciation, causing a vicious circle of further asset write offs. Hence the need for IMF and Central European Bank support to the banking system to prevent a liquidity crisis on top of the government debt crisis.

Total Euro sovereign debt to GDP figures are not dissimilar in percentage terms to the United States (debt US\$14,700 billion to GDP US\$15,000 billion) so the European debt problem shouldn't be causing as big a problem as it is. Yet, until the separation of monetary policy (European Central Bank responsibility) and fiscal policy (sovereign government responsibility) is resolved by either certain countries leaving the Euro (debt effectively written off with large but swift losses) or certain countries effectively handing over fiscal sovereignty to a central European authority (less debt written off and ECB rescue packages) the uncertainty will continue and harsh austerity measures are all that is available. The future direction of Europe is at hand and I suspect the stakes are bigger than the underlying problem being fought over.

Portfolio Reviewed

It is funny where investing lessons can be learnt. There is a movie out at the moment about baseball called 'Moneyball'. Like many good movies it is based on an even better book. The story is about a major league baseball team competing at a distinct financial disadvantage to the more powerful clubs who buy its best players once they become free agents (players can switch clubs at will after their first six years in the league). The book examines how this low budget team is able to consistently outplay richer teams who have spent three or four times as much on players.

At the heart of this team's success lies a baseball statistic that was completely misunderstood, 'walks'. A walk is when a pitcher throws four 'balls' (outside the strike zone) before he throws three strikes allowing the batter to go to first base without hitting the ball. A walk was traditionally put down to a pitcher's error, not dissimilar to a no ball in cricket (it was an Englishman who set up baseball statistics). What this team recognised, that others didn't, was that a 'walk' was not in fact a pitcher's error but a batter's skill, ie. having an eye and temperament good enough to leave pitches outside the strike zone that resulted in a batter getting to first base. At minimal expense a team capable of getting on base through walks was assembled. All of those 'walks' added up to many home runs that in turn resulted in a record winning streak.

The importance of this story, in highlighting the value of leaving pitches outside the strike zone, is a concept that equally applies to investing. Don't invest in what you don't have to. It leads to lower portfolio turnover but portfolios with investment ideas of a high conviction. This is my preferred style of investing.

While many clients differ in their investment profiles and portfolio needs, there exists a group of a dozen or so commonly held stocks for which we should all hope that their earnings grow. In any given year some of these businesses will do better than others, but if it transpires that they successfully grow their earnings as a group, then the equity components of our portfolios will rise along with a growing stream of dividends. Anyway, that is the plan.

In the portfolio review I focus on these stocks. Working on the notion that good news looks after itself (four stocks gained during the period, four met market and four performed worse than market) I give emphasis to those investment swings that are not panning out as expected.

Billabong – A study on how a stock goes from \$18 to \$1.80

In Billabong's trading update on 19 December 2011, it became apparent that early December sales in Australia were falling close to 20%, while European sales were dropping 30%, compared to the previous period in 2010. To put the significance of these falls into perspective, at the climax of the GFC crisis in the US (with Californian unemployment around 20% and probably in depression), across the board US surf store sales dropped 20%.

Subsequent to the announcement, the price reacted horribly and more than halved from its previous \$4 close. There was a week-long barrage of articles in the mainstream and financial press written with authority all claiming to know what the problem was with Billabong. I endured most of those articles, with the only solace coming from a visit to the dentist, but struggled to find even one article sufficiently close to the problem. Before I tell the story of Billabong, let me make it clear the problem does not reside in a meaningful way with Billabong the brand, even though brands do have limited life cycles. Sales of Billabong branded products (Billabong hats,

Billabong board shorts etc) in Australia make up only 9% (approximate) of global company sales. There is a different story to that which has been mainly reported.

Rather than starting the story of Billabong with Gordon Merchant, founder and major shareholder, cutting cloth to make board shorts on his kitchen table in 1973, I'm going to start in mid 2007 with the stock price at an all time high above \$18, a forecast PER of 22 and the company on its way to a record 2008 profit of \$176.4 million (consensus 2012 earnings are \$62 million).

By 2007 Billabong was well advanced in developing its multistep focused strategy for the global board sports market. Billabong was concentrating on board sports involving surfing, skateboarding and snowboarding while selling all the key product categories associated within those sports, from apparel including clothing, eyewear, and watches to hardware such as boards. Rather than trying to take Billabong the brand and turn it into all things to all people, which would have failed, Billabong selectively purchased and nurtured other key existing brands for each category of each market, then took those brands global. Since 2002 Billabong had accumulated Von Zipper eyewear, Element – global leading skateboard company, Nixon watches, Kustom footwear, Xcel wetsuits, Sector 9 skateboard and DaKine specialist accessories. Simultaneously Billabong was distributing new product lines into its traditional markets - the US and Australia - as it was developing emerging markets for its total suite of offerings in Japan, Brazil, Italy, Germany, South Africa etc.

Billabong was successfully selling more products to more people and importantly for more money. Between 2002 and the 2008 financial year sales grew from AUD\$500 million to AUD \$1,350 million and profit grew from AUD\$61 million to AUD\$176 million, while earning incremental returns on capital in the 20% range. In the vernacular of one of Billabong's customers 'life was sweet bro'.

What follows is the financial record of Billabong between 2007/08 and 2011/12 (estimated) and an examination of the financial influences that have since shaped Billabong.

in Australian Dollars, millions		2007/08	2008/09	2009/10	2010/11	2011/12 (est)	change	change %
Operating Profit								
Australasia		110	100	89	55.4	46	64	-58%
America's		112	100	92	80.4	79	33	-29%
Europe		68	82	70	54	32	36	-53%
Total operating profit		290	282	252	190	157	133	-46%
Depreciation		-28	-38	-36	-42	-41	13	
Interest expense		-19	-31	-15	-23	-35	16	
taxation		-69	-55	-58	-9	-20	-49	
other		2	2	2	2	2	0	
Reported Profit		176	160	146	119	63	113	-64%

Billabong's profitability has been impacted by five key influences between 2007/08 and 2011/12 (estimate). They have been the Global Financial Crisis (GFC), continued appreciation of the Australian Dollar, the natural disasters of the Asia Pacific rim, the emergence of the European economic crisis and the key decision of Billabong management to increase the percentage of

sales from company operated stores from 18% to 38% of global sales. As can be observed, operating profit will most likely have fallen \$133 million by the end of this financial year. This 46% reduction in operating profitability plus the increased depreciation and interest charges (reflecting more assets and more debt) have been the catalyst for the market capitalization of Billabong falling from \$4 billion to around \$480 million today.

To gain a clearer picture as to what happened between 2007/08 and 2011/12 (estimated) I have stripped out the yearly change in operating profit for each region and identified the most influential events surrounding that period.

Operating Profit, \$AUD millions	2008/09	2009/10	2010/11	2011/12 (est)	total
Australasia	-10(GFC)	-11(GFC)	-34(disasters)	-9(Euro crisis)	-64
America's	-12(GFC)	-8(FX)	-12(FX)	-1(Euro crisis)	-33
Europe	14(FX)	-12(FX)	-16(Euro crisis)	-22(Euro crisis)	-36
	-8	-31	-62	-32	-133
Cause					
GFC	-33	25%			
FX	-18	14%			
Natural Disaster	-34	26%			
Euro crisis	-48	36%			
	-133	100%			

2007/08 – profit AUD\$176 million.

Profit grew despite the commencement of the GFC because Billabong, being a wholesaler (18% of sales did come from company owned stores), had forward sales already in place. The stock market is forward looking, and the market anticipated trouble, with the stock price \$10.50 at year end.

2008/09 – profit AUD\$160 million (down 9%)

As can be seen from the second table of data above, the GFC took its toll on Billabong in Australasia (Australia, New Zealand, Japan, Malaysia, South Africa etc) and the America's region (US, Canada, Brazil etc). The drop in profit in the America's would have been worse had the Australian dollar not fallen from near parity to USD 60 cents. European operations were unaffected by the GFC and European earnings rose when reported back in the weaker Australian dollar.

An important development occurred in the US in 2008/09 when Billabong's main US wholesale customer, Pacific Sunwear, pursued a strategy to shift into a value price driven retail offering (sounds like they wanted to be the Best & Less of surfing). New management at PacSun decided to sell home branded products rather than heritage brands like Billabong (the brand) and Element. This cost Billabong sales and profitability and eventually got PacSun management fired as the company lost enormous amounts of money selling products their customers didn't want (new management eventually switched back to heritage brands). PacSun's strategic mistake not only shot itself in the foot but shot Billabong as well. It is likely this experience was the cause that accelerated managements desire to control more of its distribution through direct

store ownership where pricing pressure could be better controlled and the dumb decisions of others would be neutralized. What better time to purchase retail operations when they were going cheap. The impact of buying retail businesses under pressure would be to add to group sales but not profitability, that would have to wait until economic conditions improved.

The stock closed the financial year at \$8.50 and this was the first financial year we purchased the stock.

2009/10 – profit AUD\$146 million (down 8.7%)

In 2008/09 the Australian dollar recovered (back to USD90 cents) and while European and America's operating profits were marginally up in their local currencies, they were down when reported in Australian dollars. Australasia experienced further earnings weakness, but unlike last year, it was in Australia as the economy stalled without the government stimulus support.

Billabong bought the RVCA brand and West 49's 138 Canadian stores. Billabong also entered online sales with the purchase of Swell. Billabong now has the number one surf retail website in Australia with Surfstich and in the US with Swell.

In 2009/10 Billabong had made progress towards protecting its pricing power – crucial to past and future success. The challenge of selling down inventory from newly purchased store networks and replenishing them with their own market leading suite of products still had to occur but Billabong had seen off the worst of the GFC impact and should have been looking forward to a recovery in the US market, and with it a recovery in profitability.

The stock closed the financial year at \$9.

2010/11 – profit AUD\$119 million (down 18.5%)

Sometimes you can find yourself standing in the wrong place at the wrong time, and then move to only find yourself wishing you were back where you started. Even though their troubles were immaterial compared to others, I wonder if that was what Billabong management thought of 2010/11.

Billabong took the opportunity to eliminate another PacSun situation, gain vertical margins and cost rationalization by buying the 588 store Surf Dive & Ski and Jetty Surf businesses in October 2010. The timing was terrible with Australia experiencing devastating floods three months later in January, NZ suffering the Christchurch earthquake in February and Japan suffering the tsunami in March. Australasian profitability was materially impacted by these natural disasters (and the man made one of the timing of the store purchases). Profitability in the Australasian region fell a further \$34 million.

Sales trends in the US improved but further Australian dollar strengthening caused Australian dollar reported earnings to fall. Europe started to experience the austerity measures in the UK and Southern Europe, and coupled with the weakening Euro against the Australian dollar, saw lower reported earnings from the Euro region.

By the end of 2010/2011 the operational outlook for Billabong was that the US operations seemed well placed. The problems in Australasia, while devastating to the regions involved, would be cycled through in due course, and Europe's economic gathering dark clouds could be managed with meaningful discussion and steps taken to rectify the situation by those in power.

The stock closed the financial year at \$6.

20011/12 – profit (estimated) AUD 62 million (down 48%)

In August 2011 Billabong management withdrew its estimate of 10% earnings growth for 2011/12 citing a lack of clarity in the timing needed to transition towards the new strategy. The market gave up on the stock selling it down to \$2.80.

Without the prospect of immediate earnings recovery, the market had decided cash flow was going to come under pressure as the company had to fund the debt from store acquisitions, make residual payouts for past brand acquisitions and hold ballooning inventory associated with replenishing new stores with their own inventory, while clearing inherited inventory. The market focus had switched to the potential of a dilutive capital raise.

By the October 2011 AGM, Billabong was reporting sales growth and anticipated strong underlying EBITDA growth (minimal tax was paid the previous year). The stock price recovered to \$4.50 and there was light at the end of the tunnel.

Then on 19 December 2011 Billabong warned (along with many other retailers such as JB-Hi Fi and Kathmandu) that Australian and European sales had fallen off a cliff in their crucial Christmas trading period. It is hard to explain what had happened in Australia, but Europe's situation can be attributed to an economic and political deadlock impacting consumer behavior. The market reacted once again to the fears of a dilutive capital raise, and that is how a stock falls from \$18 to \$1.80.

Such a fall from grace is a sad tale. In the period just reviewed earnings are due to have fallen \$100 per annum while the market capitalization has fallen by \$3.5 billion or from \$4 billion to \$480 million (debt had increased by about \$350 million).

While the sequence of poor economic environments, unfavorable currency moves and natural disasters are largely responsible for the deterioration in profitability, the decision to implement a strategy to protect operating margins at a time retail operations were cheap and available to be bought, increased the short term risk by introducing operating and financial leverage. It is Billabong's fault that the additional operating and interest costs have compounded the situation and that the higher debt levels have given cause for a potential capital raise.

Is all lost? The private market for brands of this nature have recently changed hands at a value of 10 to 14 times operating profit while Billabong, even with its very depressed earnings, is trading near half this. Meanwhile Nike who operates the brands Converse, Hurley and Nike 6.0 has stated a desire to double sales in the board sports market over the next five years to USD\$500 million, and is even co-hosting events with Billabong now. While the stock market has its doubts, there is value in Billabong.

Billabong's sales are anticipated to exceed \$1.7 billion this year and while sales growth in the recent past has been unprofitable, it won't always be this way. The America's region continues to slowly improve, the Australasian region surely can't have a worse period than calendar year 2011 which started with natural disasters and ended with a shocking December, while Europe is already operating at the level everyone fears. The strategy to increase store ownership to 38% of group sales will eventually see the inherited inventory from the purchased stores sold down

and replaced by Billabong's suite of products, and with it a return to stronger profit margins. Billabong is like a compressed coil spring and all it needs is time.

To go back to 'Moneyball' - is the markets pitch of \$1.80 for Billabong shares a ball we should leave or a pitch we should swing at? Should earnings get the chance to recover, then my guess is there is potential for serious upside in the stock price, but the implications of the debt obligations immediately facing the company complicates the situation enormously. Management has material exposure to the stock but is not buying (unlike Gerry Harvey who has been buying). So it is difficult to tell what to do and maybe I'm the boy who cried wolf on this one too many times. I haven't lost faith in Billabong, just face.

Far from ending on such a dispirited note, we can be heartened by the positive start to January 2012 and maybe the saying 'as goes January, so goes the year' might prevail. Also, we have added a new business to our preferred stock holdings which operates in the business to business field. Interestingly Warren Buffett's last six major stock and business acquisitions (excluding financials), have been operators in the business to business field, with 5% of IBM being the latest. Hopefully we are in good company.

While much of what is being reported seems gloomy, consider the following. Around the time the stock markets of the world bottomed in 2008/09, \$100,000 would have bought about \$60,000 US dollars worth of stock. Today that USD\$60,000 of stock would be worth USD\$111,000 with the US market advancing a significant 85%. Alternatively, if you had done nothing and kept the \$100,000 dollars invested locally, it would have grown 39% to be worth AUD\$139,000. But, with the exchange rate higher at \$1.05 you can now buy \$146,000 US dollars of stock leaving you 30% richer in US dollar terms. It might not feel like it but we are all a lot wealthier than we think just by being in Australia.

Please let me know if anything in this letter or that occurred during the half year needs clarifying.

Yours sincerely

Justin J O'Kane, CFA