CONTRARIUS

# QUARTERLY INVESTOR COMMENTARY
# 30 JUNE 2016

## CONTRARIUS GLOBAL EQUITY FUND

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*The Fund aims to earn a higher Total Rate of Return than the average of the world's equity markets, as represented by the MSCI World Index, including the reinvestment of dividends net of withholding tax ("World Index"). It aims to achieve this without greater risk of loss, over the long-term. The Fund is an actively managed fund, and as such does not in any way seek to replicate its benchmark index, but may instead differ materially from the performance benchmark in order to achieve its objective.*

**CONTRARIUS GLOBAL EQUITY FUND AT 30 JUNE 2016**

| Total Rate of Return in US Dollars | Class | Since Inception on 1 Jan 2009 | Latest 5 Years | Latest 3 Years | Latest 1 Year | 2016 Year-to-date | Latest Quarter |
|---|---|---|---|---|---|---|---|
| | | | *% Annualised* | | | *% Not Annualised* | |
| **Contrarius Global Equity** | **Investor** | **18.8** | **9.8** | **8.4** | **3.4** | **27.5** | **9.2** |
| **Contrarius Global Equity** | **Institutional** | **19.3** | **10.2** | **8.9** | **3.9** | **27.8** | **9.3** |
| World Index | | 10.5 | 6.6 | 6.9 | (2.8) | 0.7 | 1.0 |

*Past performance is not a reliable indicator of future results.*

The Fund's Investor Class shares returned 9.2% for the quarter versus 1.0% for the benchmark MSCI World Index, including reinvested net income. As we have highlighted previously, our investment philosophy is not benchmark cognisant and our portfolios would normally vary materially from the benchmark World Index. The Fund's returns are therefore likely to deviate from those of the benchmark. Investors are reminded that given the long-term, contrarian, valuation-based investment philosophy, there will be times when the Fund will materially underperform its benchmark in the short-term in order to achieve its objective of long-term outperformance.

The Fund remains overweight Materials, Technology and Energy stocks. In terms of geographic exposure, the Fund continues to be significantly underweight European equities and overweight shares outside the major developed markets.

| Sector Exposure 30 June 2016 | Weighting (%) Fund | World Index [1] | Over/(Under) Weight |
|---|---|---|---|
| Energy | 14 | 7 | 7 |
| Materials | 36 | 5 | 31 |
| Industrials | 1 | 11 | (10) |
| Consumer Discretionary | 18 | 12 | 5 |
| Consumer Staples | 1 | 11 | (11) |
| Health Care | 1 | 13 | (12) |
| Financials | 4 | 19 | (15) |
| Information Technology | 25 | 14 | 11 |
| Telecommunication Services | 0 | 4 | (4) |
| Utilities | 0 | 4 | (4) |
| **Total Shares** | **99** | **100** | |
| Net Current Assets | 1 | - | |
| **Net Assets** | **100** | **100** | |

[1] *Source: MSCI (attention is drawn to MSCI disclaimer in 'Notices')*

| Geographic Exposure 30 June 2016 | Weighting (%) Fund | World Index [1] | Over/(Under) Weight |
|---|---|---|---|
| North America | 55 | 63 | (9) |
| Europe | 6 | 23 | (18) |
| Japan | 3 | 9 | (5) |
| Asia ex-Japan | 15 | 2 | 13 |
| Other | 21 | 3 | 18 |
| **Total Shares** | **99** | **100** | |
| Net Current Assets | 1 | - | |
| **Net Assets** | **100** | **100** | |

[1] *Source: MSCI (attention is drawn to MSCI disclaimer in 'Notices')*

The Chinese economy has been making headlines for just about two decades. For much of that time the news was rosy: strong growth, falling poverty, emerging middle class, vibrant consumption. In 2008, China consumed between 25% and 60% of the world's iron ore, aluminium, nickel, zinc, and copper. But recent headlines are grim: over-building, lending bubbles, crackdowns on conspicuous consumption, torpid consumer spending. It may not be surprising that the auto industry—the posterchild of discretionary consumer spending—is in a funk.

Luckily for us, it is just those conditions that sometimes throw out interesting shares. We expect the long-term outlook for car sales in China to remain good, even if the short term may be rocky. The Fund holds two Chinese auto-related shares that we believe are attractive, one of which is Bitauto Holdings (Bitauto).

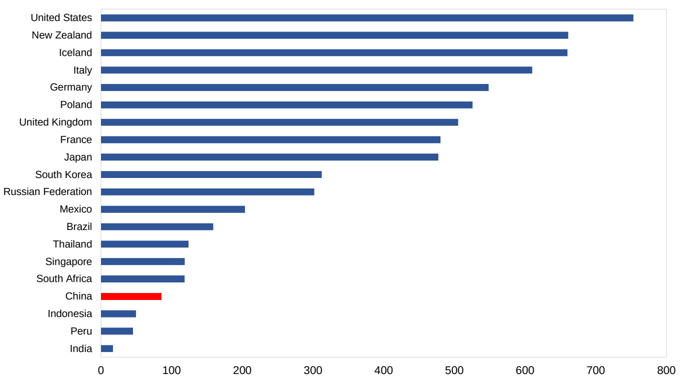
## BITAUTO HOLDINGS

Bitauto is an online aggregator of car dealers. It lists more than 26 million vehicles and publishes reviews, advice, and other auto-related content. Revenues come mainly from dealer subscriptions for listing their inventories (and some other services) and selling advertising space on its websites to automakers and dealers. A number of long-term forces are in its favour: car ownership, internet connectivity, and the shifting structure of advertising spending (online vs offline; targeted vs broad).

### *Chinese Auto Market*

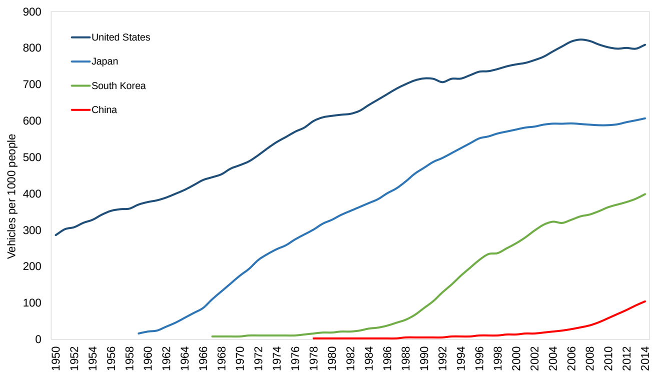
China has about 85 passenger cars for every thousand people, compared to 750 in the US, 660 in New Zealand, 530 in Poland, 500 in the UK, and 300 in Russia (Figure 1). That has been increasing rapidly (Figure 2) as new passenger vehicle sales went from 7 million in 2008 to 21 million in 2015. It may be optimistic to expect China ever to reach current US levels, in part because the US number is likely to fall from here as public transport, car-pooling, connected taxis (e.g. Uber), and self-driving vehicles dent the car's iconic status. But, as well as the gap being vast, those alternatives are attractive mainly in high-density urban areas, where 81% of US residents live compared to 54% of Chinese. We expect sales to climb as the country gets richer (GDP growth is about 6% per annum, despite the slowdown).

**Figure 1: Passenger cars per 1000 people**




Source: Contrarius Research, OICA, U.S. Department of Transportation, World Bank

**Figure 2: Motor vehicles per 1000 people**

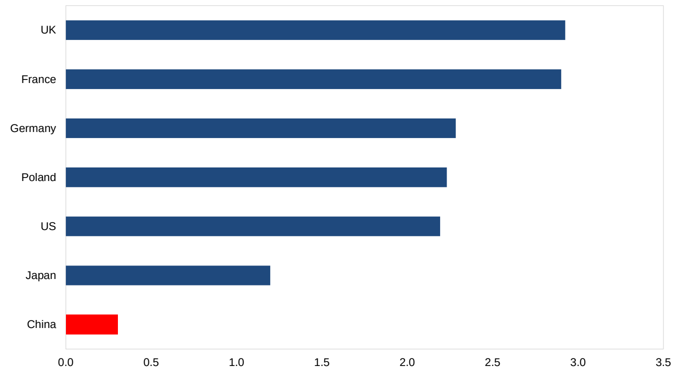



Source: Contrarius Research, OICA, U.S. Department of Energy, World Bank, Reserve Bank of Australia

Used cars have, to date, not played much part in the Chinese market. In 2015, one used car was sold for every three new cars, compared to more developed markets where used car sales typically outnumber new ones 2:1 (Figure 3). The government has recently changed policies that historically favoured new vehicles. We expect that a burgeoning fleet of used cars would be a boon for Bitauto in a number of ways. Firstly, they tend to be more profitable for dealers, which will likely prompt them to spend more on advertising. Secondly, a big pool of used cars lowers the affordability threshold, which we expect will be good for volumes.

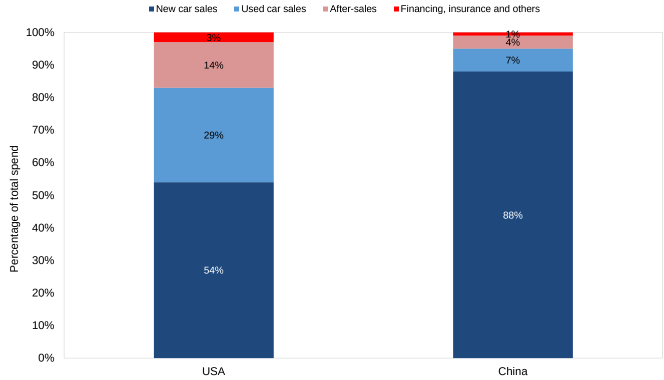
But perhaps most importantly, used cars should give Bitauto and Autohome, another of the Fund's holdings, a competitive moat. A new car is a commodity product: you will get the identical item wherever you shop. As a buyer, it doesn't much matter to you whether you go to Dealer A or Dealer B, which is why dealer margins on new cars tend to be so thin. So an aggregator of new car inventory is mainly a convenience rather than a necessity. But used cars are not commodity products. They suit different buyers, depending on the trade-offs the individual is willing to make. Each dealer will have different inventory. A buyer may be able to see a handful of appropriate cars at a nearby dealer, but hundreds or thousands of nearby cars on Bitauto's website. This is more than a mere convenience. We expect that the network effect this creates—with sellers wanting to be where the buyers are, and buyers wanting to be where the sellers are—will make it hard for newcomers to put pressure on Bitauto and Autohome.

**Figure 3: Vehicle sales: used-to-new volume ratio (2015)**




Source: Contrarius Research, OICA, Edmunds.com, respective national automobile associations

**Figure 4: Auto dealer revenue**

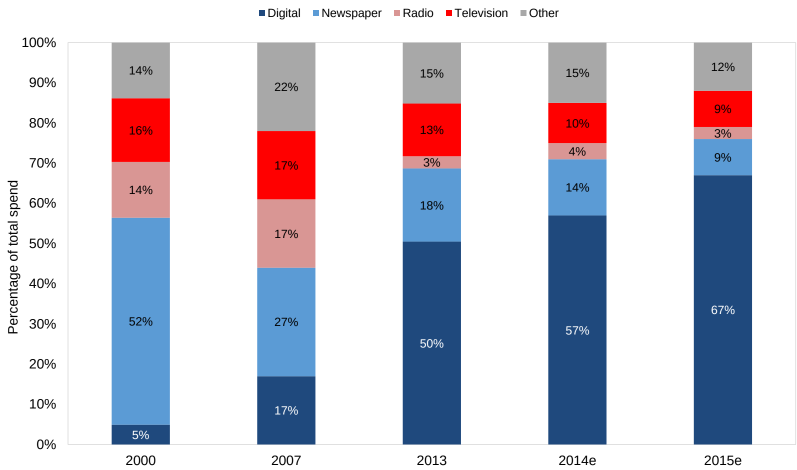



Source: Contrarius Research, Deloitte, China CITIC Bank

## *Auto Advertising in China*

Advertising intensity in China, at around 0.6% of GDP, is now at similar levels to more developed countries, like Italy, France, Canada and Germany (but well behind the long-term US spend, at 1.3% of GDP). But online advertising is still in its infancy. In the US about 67% of automotive advertising spend is online (Figure 5), having grown from less than $4 billion in 2011 to about $7 billion in 2015. In China, only 27% of automotive advertising spend is online, but this is increasing rapidly (Figure 6).

**Figure 5: US car dealer ad spending**



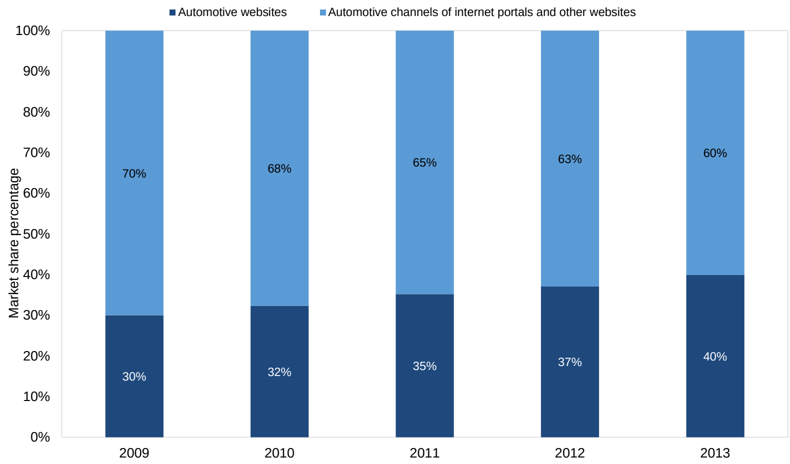

Source: Contrarius Research, National Association of Auto Dealers, Borrell Associates

| Figure 6: Chinese automotive advertising spending | Change: 2009-2013 |
|---|---|
| Total automotive advertising | 56% |
| Offline automotive advertising | 39% |
| Online automotive advertising | 199% |

Source: Contrarius Research, Autohome

Even this understates the advertising opportunity. As destination sites specifically for potential auto buyers, Bitauto and its auto-specific peers are highly targeted compared to the general internet portals. The share of automotive advertising captured by these sites has already gone from 30% in 2009 to 40% in 2013 and we expect it to go much higher. In 2015, Bitauto and Autohome—the two auto aggregators owned by the fund, and also the two biggest—together accounted for more than 90% of automaker's online spending on auto aggregators, so they are likely to capture the majority of this growth.

Figure 7: Online automotive advertising spending in China




Source: Contrarius Research, Autohome

*Aggregators*

The internet's key gift to business is perhaps zero marginal distribution cost (almost). If your website can reach a thousand people, it can probably reach a hundred thousand, or even ten million, with minimal additional cost. This has ravaged businesses that depended on distribution friction. Consider local newspapers, for example. Your local newspaper (assuming there was one dominant one) used to be an excellent business. It was expensive for other local newspapers in nearby towns to distribute far beyond their borders. So your local newspaper had a captive audience, and could charge high fees to advertisers. But with the internet any newspaper in the world can distribute into your town at negligible cost. Your audience leaks out, decimating your leverage with advertisers. Local newspapers are struggling.

But there's a creative side to this destruction. Zero marginal distribution cost has enabled a new category of excellent businesses: aggregators. Aggregators serve information from many sources, typically summarised according to your individual interests. The successful ones become destination sites, appropriating the customer relationship from the service provider. The model is simple but formidable. After years of wrangling over intellectual property rights, in 2013 Google changed its Google News aggregator to be an opt-in service for German publishers. In October 2014, Axel Springer (Germany's biggest publisher), among others, opted out. Traffic to its properties tumbled and after about two weeks it opted back in. In another example, real estate agents in the UK have said that they have little choice but to put their inventory on Rightmove. Once one or two aggregators are dominant, they become very resistant to competition. Combined with their capital-light business models, this makes them excellent businesses.

**Figure 8: Aggregators - selected financial metrics (latest financial year)**

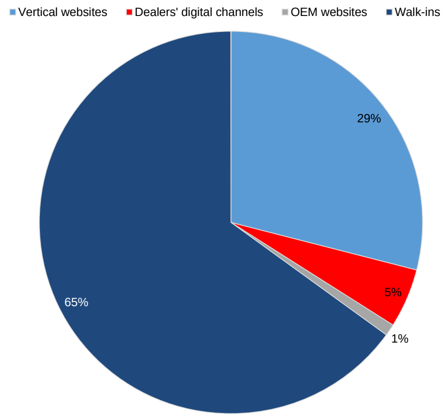
| | Industry | Free Cash Flow Margin | Growth in Revenue per Share | Return on Equity |
|---|---|---|---|---|
| Auto Trader UK | Auto | 24% | 8% | -246% [1] |
| Carsales.com | Auto | 31% | 32% | 50% |
| Rightmove | Property | 60% | 18% | 2410% |
| REA Group | Property | 34% | 20% | 44% |
| Zoopla | Property | 36% | 34% | 24% |
| Expedia | Travel | 9% | 15% | 23% |
| Priceline | Travel | 32% | 12% | 29% |

Source: Contrarius Research, Bloomberg

[1.] Shareholder equity is negative

Bitauto's web interface means that every dealer potentially has access to every person in China with an internet connection, about half the population and increasing. Between 2011 and 2015, daily visitors, time spent on Bitauto sites, and monthly page views all more than doubled. In the same period the number of dealers on the platform went from about 6,300 to about 25,000 and subscription revenues followed. The aggregators now generate about 30% of sales leads (compared to 5% from the dealers' own websites, and 1% from automakers' websites; Figure 9). We expect that the budding market for used cars, which is where Bitauto is of most value to buyers, will entrench its competitive position.

**Figure 9: Share of China auto sales by source of leads (2015)**




Source: Contrarius Research, McKinsey & Company

## CONCLUSION

Bitauto's share price has been swept along with the change in sentiment toward China. It has fallen more than 70% since it peaked in 2014 and now trades on a low multiple of our estimate of normal free cash flow. Moreover, it has about a third of its market cap in net cash. This seems far too cheap for a long-term growth business in a strong competitive position. JD.com, another of the Fund's holdings, as well as Tencent own material stakes (JD.com owns 24% of the common shares and was also the primary participant in a recent share issue). Autohome's management, presumably agreeing with our view on the prospects of the business, is currently trying to buy out Autohome at what we believe is a low price. The negative headlines may well be right: China may suffer from bad debts, falling property prices, and a consumer spending drought. And the shares may suffer further. But we believe that Bitauto has the balance sheet to see out the tough times, and an excellent business model to capitalise on what we believe to be enduring and powerful economic forces.

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**Contact.** Correspondence in relation to Contrarius Investment Management Limited's business can be addressed to 2 Bond Street, St Helier, Jersey, JE2 3NP, Channel Islands or clientservice@contrarius.com.