UniSuper

June 2014

Investment market update

Global share markets continued to push higher in May. Increased confidence that the European Central Bank would deliver additional easing at its June meeting, along with lower bond yields helped strengthen the search for yield. Investors' nerves were also calmed by a period of relative stability in tensions between Ukraine and Russia. In this month's update we look at the very topical and controversial Westfield / Westfield Retail Trust restructure proposal. Westfield Retail Trust is held in several of our investment options so we have taken a highly public stance in the interest of protecting our members' interests.

PERFORMANCE OF KEY MARKETS

	% CHANGE				
	MONTH	FYTD	1 YEAR	3 YEARS P.A.	5 YEARS P.A.
Australian Shares (ASX 300)	0.6	19.0	16.1	9.7	12.1
US Shares (S&P 500) in US Dollars	2.3	22.1	20.4	15.1	18.4
US Shares (S&P 500) in Australian Dollars	1.9	20.0	24.1	20.5	14.9
Asian Shares (MSCI Asia)	3.1	9.9	4.0	0.4	7.0
Australian Dollar (AUD/USD)	0.5	1.7	-2.9	-4.4	3.1
Australian Fixed Interest (UBSA Composite)	1.4	5.2	4.1	6.9	6.6
Cash (UBSA Bank Bill)	0.2	2.5	2.7	3.6	3.9
Balanced option*	**1.1**	**13.6**	**13.0**	**10.0**	**10.1**

Returns are for periods to 31 May 2014. Past performance is not an indication of future performance.
* Returns relate to our Accumulation (not Pension) investment options and are published after fund taxes and investment expenses, other than account-based fees.
See performance information on all options

The Westfield Restructure Plan (B) —rebels say "bring it on"

BACKGROUND

The clippings on the following page (Financial Review 2 June 2014) refer to UniSuper's public stance on parts of a restructure proposal put forward by the Boards of Westfield Group (WDC) and Westfield Retail Trust (WRT). Before delving into the recent issues, let's first revisit the background to UniSuper's investment in Westfield Retail Trust.

Westfield Group is Australia's pre-eminent owner, manager and developer of shopping centres. WRT was spun out of Westfield Group in 2010 and currently owns $13.6 billion of property across 46 malls. Locations of flagship centres include Bondi, Sydney CBD, Doncaster, Chermside, Carindale and Marion.

Most importantly, WRT's business model is effectively that of a 'rent collecting landlord'. Developing and managing the shopping centres, typically a riskier business, is effectively outsourced to WDC, and this entrenched relationship is governed by a management contract.

> "The biggest shareholder in the Westfield Retail Trust has challenged the powerful Lowy family to carry through on their threat to take on the trust.
> "Bring it on," said John Pearce, the chief investment officer of UniSuper, which owns 8.49 per cent of the trust is fighting the $70 billion restructure of the Westfield empire." …
>
> FINANCIAL REVIEW SUNDAY

> "Steven Lowy hits at "hysteria" over Westfield plan"
>
> "Investor dares family to compete"

Apart from the low-risk nature of its business model, other characteristics that make WRT an excellent asset for UniSuper include:

- **Inflation protection:** the growth in value of high quality retail properties, such as those owned by WRT, has historically proven to exceed inflation. Investment returns are ultimately a function of rental income received from tenants, and well positioned centres have been able to negotiate rental increases in excess of the inflation rate.
- **High quality assets:** WRT's portfolio predominantly consists of "fortress" malls that dominate their catchments and thus can grow their market share.
- **Excellent manager:** WRT malls are managed by Westfield Group, one of the world's leading shopping centre managers and developers. Westfield Group has an exceptional 50-year track record of developing and managing retail property, delivering strong returns to its owners.
- **Sound balance sheet:** WRT has a solid balance sheet which is conservatively geared (currently around 22%) with a sector leading credit rating of A+ from Standard & Poor's.

UNISUPER'S INVESTMENT IN WRT

UniSuper started to accumulate a significant stake (currently 8.5%) in WRT in early 2012 at a price of around $2.70 per security. Apart from being attracted by the characteristics outlined above, the entry price represented a discount to the net asset value of about 17%, giving us (to use Warren Buffett's terminology) a "margin of safety".

Since our initial investment, the price has appreciated (currently $3.20), and we have also received the following dividends.

6 MONTHS ENDING	DISTRIBUTIONS (cents per security)
June 2011	8.10
December 2011	8.40
June 2012	9.25
December 2012	9.50
June 2013	9.93
December 2013	9.93
2014 Forecast (full year)	20.40

Source: WRT market disclosures. Past performance is not an indicator of future performance.

At the current price, total returns since our initial investment is 11.2% p.a. compared to 8.1% p.a. for the broader Australian equities market over the same timeframe.

THE RESTRUCTURE PROPOSAL —CREATION OF THE 'SCENTRE GROUP'

In December 2013, a joint proposal was announced by WDC and WRT to form Scentre Group. Key aspects of the proposal include:

- All of WRT's assets, and the Australasian assets of WDC to be folded into Scentre Group.
- WRT security holders would contribute 69% of the property assets and own 51.4% of the securities of Scentre.
- WDC would contribute 31% of the property assets plus management and development rights and own 48.6% of Scentre.
- The gearing levels of Scentre would initially be 37%, although management have committed to bring this down to 30% - 35%.

WHY ARE WE "REBELLING" AGAINST THE PROPOSAL?

At a high level, one can see that Scentre is a fundamentally different proposition to WRT. We bought into WRT because it was a lowly geared landlord, earning steadily growing rental streams, which ultimately convert into growing dividends.

Scentre has much higher levels of gearing, and also adds risk associated with property development management fees. In simple terms one could say we bought an apple, and now we are being asked to accept an orange.

Since the time of our initial investment, we have been very clear in our communication to WRT management in relation to corporate strategy.

The other major sticking points for us revolve around cost and price. The big winners from restructures are invariably the lawyers, bankers, and other 'experts' and this proposal is no exception, with the bill estimated to be around $75 million plus a further $350 million of refinancing costs. WRT will therefore be asked to pick up a huge tab for something we didn't want in the first place.

The difference between the proportion of assets WRT is contributing to Scentre (69%) and the ultimate ownership (51.4%) is effectively payment for management rights that WDC will relinquish to Scentre. The independent expert has deemed this to be a fair price, but we strongly disagree. The valuation ascribed by the independent expert implies a level of property development management fees, *in perpetuity*, which we simply cannot reconcile. The property experts we speak to agree. Suffice to say that we are far apart in terms of fair valuation.

In our view this deal simply represents a transfer of value from WRT to WDC.

So the scene was set for a 29 May 2014 meeting when security holders of WRT were asked to vote. The proposal needed 75% approval to pass, which means our 8.5% stake was extremely important. Security holders could vote in two ways being (a) prior to the meeting by lodging proxies or (b) by physically turning up at the meeting and voting. Most institutions lodge electronically so before the meeting started a very large proportion of the votes had been lodged. The vote at this point was approximately 74.2% 'for' and 25.8% 'against'.

A simple interpretation of the proxy vote outcome is that the vast bulk of security holders were in favour of the proposal, and hence the labelling of UniSuper as being in the "rebel" camp. The label is unfair and misleading because:

1. The 74.2% *'for'* vote belies the fact that a significant portion of these votes potentially represented security holders that also own WDC. Indeed many security holders actually own a lot more WDC than WRT. Given that the restructure, in our view, equates to a transfer of value from WRT to WDC it came as no surprise to us that the 'for' vote was so large. The corollary is that, in our view, if there was no common security holder base between WRT and WDC the proposal would have struggled to even get a simple majority in favour.
2. At UniSuper our voting must be consistent with our fiduciary responsibilities. We don't see anything rebellious in voting for the status quo, when we deem the status quo to be in our members' interests.

THE EXTRAORDINARY EVENTS OF 29 MAY 2014

The meeting itself provided an extraordinary twist to the story. The proposal was destined for defeat because, in our view, there were insufficient votes on-the-floor to change the outcome from the proxy votes lodged before the meeting. That is, until the Chairman made the extraordinary decision to postpone the meeting. The reason given was that information presented by WDC Chairman, Frank Lowy in the morning was deemed to be new information, and that this new information was material. In the Chairman's view, the information was considered material enough that WRT investors would need more time to consider their decision, or indeed change their decision if they had already voted.

The new information appears to have been Westfield's *'Plan B',* in the event that the proposal was not approved by security holders. Plan B involves the establishment of a new company (for this update let's call this 'Scentre B') housing the Australasian assets spun off by WDC. Furthermore, it was made clear to members that Scentre B would be a very attractive company competing with WRT (the "ugly sister" according to one journalist) in the marketplace for capital and assets. In other words it could be viewed as a thinly veiled warning to potential 'against' voters.

We hope that WRT security holders see through this. In our view, Scentre B will not be the attractive sister to WRT—indeed we think quite the contrary. Scentre B, after incurring the costs of a restructure, will be highly geared and be forced to sell assets as investors demand lower debt levels. This would in itself be a great outcome for WRT given that it has pre-emptive rights (i.e. first right of refusal) to purchase the properties.

Anyone assuming that Scentre B will always be trading at a premium while WRT will always be trading at a discount is displaying an ignorance of how markets actually work. As a riskier proposition, Scentre B could potentially trade at a premium in a strong bull market, but revert to a discount when investors are more cautious.

The bottom line is that we are not at all concerned about the so called 'Plan B'. Under this scenario WRT will continue to be the attractive, lowly geared, rent collecting landlord we bought in the first place. Therefore our response to Plan B is: "bring it on".

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