HYPERION ASSET MANAGEMENT

SATELLITE REPORT March 2011

Inside the investment team...

Why takeovers don't work for investors

Involvement in major merger deals equates to major investment withdrawals for Hyperion.

Takeovers, mergers and acquisitions... at Hyperion we don't like owning companies that are involved in "major" deals of this nature, either as the target or as the acquirer.

Our rigorous investment criteria are designed to maximise the likelihood of creating portfolios that will produce above benchmark returns over rolling five year periods. Our view is that major merger transactions require substantial capital investment from businesses and make it difficult to predict their future growth rates. As such, these companies represent too much of a risk to warrant inclusion in our investment portfolio.

Defining a major acquisition

Hyperion has an equation that it has developed to determine whether a transaction represents a "major" deal and calculates the impact it will have on the business it owns. It measures the size of the acquisition versus the enterprise value of the company and if that figure is greater than 35 per cent of the company's enterprise value, then Hyperion would sell its holding immediately.

If the result is greater than 10 per cent but less than 35 per cent, Hyperion would downweight the company in its portfolio. For example, Hyperion held ownership in AMP when it announced plans to merge with AXA. When Hyperion applied its equation to the merger, it fell into the 10-35 per cent category and, as a result, Hyperion reduced its holding in AMP.

As the target

Takeovers are good for shareholders of the target company if they have a short-term investment horizon (i.e. in it for a trade), or if the company is approaching maturity and doesn't have many long-term growth options ahead.

But at Hyperion, our portfolio consists mostly of companies with strong, long-term organic growth options. We don't want our companies to be purchased and as a result, our shares to be compulsorily acquired.

Although investors would receive a short-term boost to returns via a takeover premium, it generally would not compensate them for potential earnings growth and therefore, the share price increase that they miss out on in the future.

As the acquirer

Takeovers can be good for the acquiring company, but history has demonstrated that this is more the exception than the rule. Some industries, such as banking, gaming and laboratories, which are dominated by fixed-cost businesses, are more conducive to mergers or acquisitions and have a greater chance of success. The Westpac and St George merger is as an example of a successful outcome.

But for companies in other industries, most of the issues arise in the integration phase when the acquiring company tends to lose focus on the core business while attempting to merge the two organisations. Some of the main integration issues that the acquiring company can encounter include:

- Cultural clashes – it's easier for a company to recruit people with certain values than to convert them to its ways, particularly if they are acquiring a competitor. The cultural clash can impact turnover and productivity levels, resulting in decreased revenue and increased costs.
- Difficulties in integrating the systems of two companies – the reluctance of employees to learn or adapt to new systems can result in higher costs than expected.
- Supplier concentration issues for the customer that result in revenue loss.
- Information disadvantage – the target company is always going to know more than the acquiring company about its own business, so revenue and cost synergies may not be as great as forecast.

A major reason why Hyperion doesn't like its companies making major acquisitions is that we place strong emphasis on a business's track record of achieving above-average levels of profitability.

When a company makes a large acquisition, the track record of management becomes largely irrelevant as it has become a different business. How different depends on the type of acquisition, but for companies that stray from their core competency, the outcomes are particularly uncertain and they become an even greater investment risk.

A good example of this was Primary Healthcare's 2008 acquisition of Symbion Pharmacy Services. Prior to the acquisition, Primary Healthcare was predominantly a company that owned and operated medical centres. Post-acquisition, it is as much a pathology company as it is a medical centre company. In Hyperion's view, they have strayed too far outside their circle of competence.

Fosters believed they could leverage their distribution capability by slotting in a portfolio of wine brands and eliminating a sales force in its acquisition of Southcorp in 2005. What they didn't consider was the different sales skills needed to sell wine as opposed to beer. Fosters have since unwound that strategy and are in the process of demerging their wine business.

Another factor to consider is that companies that make large acquisitions often use debt to help fund the purchase and gear up their balance sheets. Hyperion has a strict 4x interest cover requirement that is often breached when companies go on the acquisition trail.

Summary

Hyperion makes it its business to buy companies with high return on capital and with strong organic growth options. This means that the companies we own generally do not need to merge or make acquisitions in order to fulfil their potential. But when a company we own does announce such a move, our investment team rigorously examines the deal and more often than not decides that it is not in our investors' interests to retain the stock.

While there may be a short-term bounce in the stock price, history has shown that the longer-term outlook for a merged entity is not positive.

Next time a company you hold is the target or the acquirer in a M&A situation, why not ask your fund manager for their thoughts on the long-term outlook for your investment.

Team committed to quality companies performing in the long-term

It is difficult to determine how long commodity prices will remain above historical averages and therefore for how long resource companies will outperform. It's equally difficult to determine how investor sentiment levels will change from period to period. However, we are unswayed by short-term noise and remain focused on buying high quality companies at a reasonable price based on the belief that superior economics will eventually be reflected in quality companies' share prices.

Market plays catch up in March with REA Group and Hyperion's carsales.com holding increased

The Hyperion Australian Equities composite and the Hyperion Australian Equities ASX 300 composite outperformed their benchmarks for the month of March. The Hyperion Australian Equities composite returned 2.72% and the Hyperion Australian Equities ASX 300 composite returned 2.88% versus the market return of 0.69%.

For the Hyperion Australian Equities composite, the largest contributors to active return were Cochlear (7.3%), REA Group (13.4%) and IRESS Market Technology (7.8%). The largest detractors from performance were Perpetual (-7.3%), our underweight relative to the benchmark position in BHP Billiton (+2.0%) and our overweight position in Macquarie Group (-3.4%).

While there has been a lack of news flow to support the share price movements for the biggest detractors and contributors to the portfolio, corporate activity was prevalent in other companies. Particularly relevant for our portfolio was the CVC Asia Pacific sell-down of its $500 million position in Carsales.com. Carsales.com was sold to help PBL Media pay off some of its debt obligations which surprised some given Carsales.com was expected to be part of Nine Entertainment Group should it be listed. Hyperion participated in the sell-down which was completed at a 5% discount to the last traded price ($4.98). The investment team felt that the discount offered during the liquidity event, coupled with the extremely strong financial result Carsales.com produced, offered an excellent opportunity to increase our holding in the company.

For the Hyperion Australian Equities ASX 300 composite, the largest contributors to active return during the month were Cochlear (7.3%), REA Group (13.4%) and IRESS Market Technology (7. 8%). The largest detractors from active performance during the month were Perpetual (-7.3%), our underweight position relative to the benchmark in Westpac Banking Corporation (+3.4%) and our overweight position in Macquarie Group (-3.4%).

REA Group's share price appreciated during March as if the market was playing catch up following a subdued February during which the company released positive financial results. It seems it has taken a concerted marketing effort by management to convince the market of the robustness of REA Group's business franchise. Italy appears increasingly likely to become a significant growth option for REA with each result and the potential for growth in the Australian market remains substantial. We are still firm believers in the story and expect that the REA Group will continue to deliver strong earnings growth over our investment time horizon.

Performance	1 mth	6 mth	1 year	2 year	5 year	Since inception (Oct 96)
Hyperion Australian Equities Composite	2.72	7.13	0.11	27.91	6.72	14.72
Excess Performance over S&P/ASX 300 Accumulation Index	2.03	-0.79	-3.68	6.54	3.51	5.04

Hyperion Australian Equities Composite Top 10 Stock Holdings		
Stock	**Absolute Weight**	**Active Weight**
RIO Tinto	8.16%	5.05
Cochlear	7.41%	7.02
BHP Billiton	6.67%	-6.51
Seek	6.39%	6.20
Commonwealth Bank of Australia	6.17%	-0.67
WorleyParsons	5.46%	4.92
Platinum Asset Management	5.11%	5.01
Woolworths	4.60%	1.85
Macquarie Group	4.59%	3.52
Sky Network Television	3.98%	3.98

Performance	1 mth	6 mth	1 year	2 year	5 year	Since inception (May 03)
Hyperion Australian Equities ASX 300 Composite	2.88	7.90	0.41	27.08	8.15	15.86
Excess Performance over S&P/ASX 300 Accumulation Index	2.19	-0.03	-3.38	5.71	4.94	4.95

Hyperion Australian Equities ASX 300 Composite Top 10 Stock Holdings		
Stock	**Absolute Weight**	**Active Weight**
Cochlear	8.48%	8.08
BHP Billiton	7.71%	-5.46
Rio Tinto	7.50%	4.39
Commonwealth Bank of Australia	6.82%	-0.02
WorleyParsons	6.25%	5.71
Seek	5.97%	5.78
Woolworths	5.26%	2.51
Macquarie Group	5.11%	4.05
Platinum Asset Management	4.71%	4.61
IRESS Market Technology	4.27%	4.19

Nick Scali's long-term story remains positive

The Hyperion High Conviction Small Growth Companies portfolio outperformed its benchmark during the month. The largest contributors to active return were REA Group (13.4%), IRESS Market Technology (7.8%) and Wotif.com Holdings (6.8%). The largest detractors from active performance during the month were Nick Scali (-15.8%), The Reject Shop (-2.1%) and Blackmores (-3.7%).

Nick Scali's result saw its EPS come in 15% below what we were expecting. This was primarily due to softer sales (when comparing across the same number of stores as last period) driven by a weaker discretionary spend environment. In addition, Nick Scali's plans to add another brand to its portfolio, targeting the entry level consumer, adds a layer of execution risk. However, we continue to believe that the Nick Scali business model is attractive to customers and shareholders over the long-term but we are aware that short-term discretionary income levels and sentiment lead to large swings in sales in the furniture industry. Due to the operating leverage in retail businesses, this results in short-term profit volatility.

Performance	1 mth	6 mth	1 year	2 year	5 year	Since inception (Oct 02)
High Conviction Small Growth Companies Portfolio	2.63	5.42	1.96	35.22	10.12	25.65
Excess Performance over S&P/ASX Small Ords Accumulation Index	2.89	-4.46	-11.53	1.29	7.32	13.95

High Conviction Small Growth Companies Portfolio Top 10 Stock Holdings		
Stock	**Absolute Weight**	**Active Weight**
IRESS Market Technology	9.56%	8.74
REA Group	9.10%	8.48
Sky Network Television	8.93%	8.93
Carsales.com	8.79%	7.83
Wotif.com Holdings	8.13%	7.57
Reckon	8.09%	8.09
Platinum Asset Management	7.09%	6.09
The Reject Shop	6.80%	6.53
Count Financial	6.18%	6.18
Navitas	4.70%	3.93

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