clime capital

Clime Capital Limited (ASX:CAM)

Quarterly Report

September 2012

www.climecapital.com.au

Dear Fellow Shareholder,

Welcome to the Clime Capital Limited (CAM) Quarterly Report.

The quarter just completed was a positive one for both the Australian equity market and the Clime portfolio. It followed a poor and volatile June quarter and whilst the market has lifted over the last year it is still well down from its recent peak seen some 18 months ago.

Such is the volatility in markets and unless an investor or shareholder is aware of this volatility then they may be oblivious the important long term outperformance of the Clime portfolio. Indeed the 3 and 5 year returns (noted below) speak for themselves and there has been a steady if not belated rise in the CAM share price. Indeed the share price improvement included numerous bonus share issues plus a growing stream of franked dividends. This has delivered shareholders a solid total return.

The recently announced 1 for 20 bonus issue is the company's fifth since June 2009 and results from a solid performance in 2011/12 plus a good first quarter investment performance. Shareholders should note that the quarterly dividend rate has been maintained on the capital increased by the bonus issues. Therefore dividends have risen by over 25% over the last 3 years.

The company's AGM will be held on the 23 of November. The Board and management of Clime look forward to meeting with our shareholders to review the company's performance and the investment outlook.

Kind Regards,

John Abernethy
Chairman

In this issue

Offer to shareholders

Clime Capital Limited ("Clime") offers investors the opportunity to invest in a value focused "closed end" Investment Company managed by a recognised top performing Australian Value Equity Manager - Clime Asset Management ("the Manager").

The Clime investment company structure offers a number of key advantages to investors.

These are:

- Clime (through its Manager's decisions) will not be a forced seller of securities in difficult times;
- Clime will not be forced buyers at inappropriate times;
- Clime pays quarterly dividends to ordinary & preference shareholders; and
- High levels of transparency by being listed on the ASX.

This allows Clime to focus on protecting and growing its capital over the longer term.

Clime invests in a diversified portfolio of Australian businesses, trusts and interest bearing securities.

Clime has a disciplined investment approach focused on the distinction between value and price. The allocation of investment capital into the market generally and stocks specifically is tempered by the Manager's continual macro-economic overlay. The company has the ability to hold elevated cash levels when market risks are considered to be excessive or value is not apparent. The Manager has the ability to look across listed asset classes to seek returns. This is a unique offering in an environment where many managers are often forced to be fully invested in one asset class with asset consultants dictating weightings.

Clime benefits from a strong and experienced team of value focused investment professionals. The Manager is the largest shareholder in Clime and thus its interests are strongly aligned with shareholders.

Ordinary Shares Overview (ASX:CAM)

Share Price	$0.975
Rolling 12 Month Dividend	$0.04
Historical Dividend Yield	4.1%
Percentage Franked	100%
Grossed Up Yield	5.9%
Dividend Reinvestment Plan	Yes

Preference Shares Overview (ASX:CAMPA)

Share Price	$1.94
Rolling 12 Month Dividend	$0.19
Historical Dividend Yield	9.8%
Percentage Franked	100%
Grossed Up Yield	14.0%
Dividend Reinvestment Plan	No

Investment Objectives & Our Process

"Clime's first preference is to deploy its capital into businesses that can self-fund their growth...."

The key objectives of Clime are:

- To preserve the capital of the company;
- To generate long term growth of capital and dividends without taking excessive risk.

The Manager seeks to achieve these objectives by purchasing the securities of companies that are understandable, that have honest and capable managers and are highly likely to generate superior returns over time. Securities will only be purchased when the price on offer is below the appraised value.

The investment approach is disciplined and transparent. The features of this approach are:

1. Securities are acquired in attractive companies when the market price on offer is at a discount to our assessment of value;
2. Positions are reduced or closed when the market price is well above the assessment of value;
3. A realistic requirement for required return is maintained so that the risk of the portfolio is properly balanced to achieve returns without risking capital;
4. Yield is sought to enhance portfolio returns through compounding; and
5. Cash will become an important asset of the portfolio when prices are expensive and value is not readily available in the market.

*"**Price** is what we pay & **Value** is what we receive."*

The Manager is firmly of the view that price and value are different concepts. Price is what we pay and value is what we receive. While the share price is freely observable, the valuation of a company requires judgement and calculation.

The investment process identifies companies that have attractive investment characteristics, applies a consistent valuation methodology, calculates a valuation for the company and identifies the companies whose share price is below our assessment of the company's value.

Clime's first preference is to deploy its capital into businesses that can self-fund their growth. These companies create value for owners by generating strong returns on equity with appropriate leverage for their business models. The profits generated by this group of businesses are best retained by the business so long as their managers can deploy retained earnings at similar "return on equity" levels. In cases where investee companies cannot redeploy retained earnings at attractive rates we look to their managers to rationally payout these profits to us as franked dividends. This allows us to make the capital allocation decision.

The Manager continually assesses investee businesses with reference to the demonstrated returns on incremental capital and the outlook for future returns on capital. Low returns on equity are not attractive nor are businesses that continually ask shareholders for additional capital.

Clime does not have current borrowings or the intention to take on debt.

Performance

The returns of Clime, under current management, have generated strong outperformance over time.

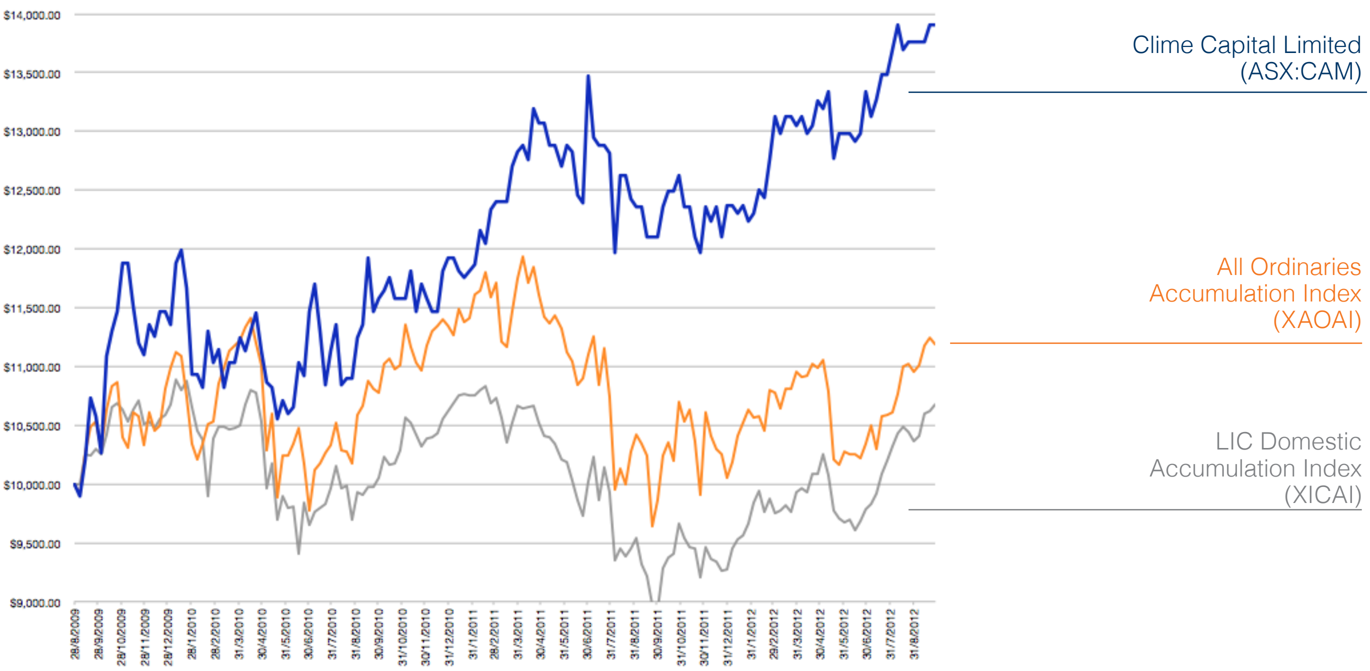
As at 30 September 2012	1 Year	3 Years
Clime Capital Total Shareholder Returns	14.9%	10.3% p.a.
LIC Domestic Accumulation Index	19.7%	1.1% p.a.
All Ordinaries Accumulation Index	13.4%	1.8% p.a.

Clime returns do not include the added benefit of franking credits which are attached to dividend distributions. Further, the returns reported for Clime are after all management and transaction costs.

More recently and despite market volatility, the Manager has ensured that Clime's capital has been maintained despite the payment of regular quarterly dividends. This has been achieved through high cash weightings and exposure to stable high yielding securities.

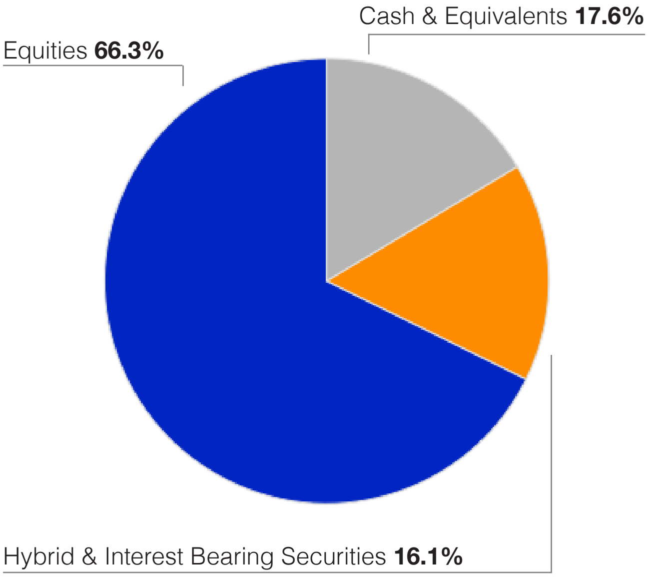
Investments	Apr '12	May '12	Jun '12	Jul '12	Aug '12	Sept '12
Listed Securities	$54.0m	$53.6m	$54.0m	$56.0m	$53.7m	$54.6m
Cash	$11.3m	$9.9m	$9.9m	$9.1m	$11.1m	$11.5m
Net Assets	$65.3m	$63.5m	$63.9m	$65.1m	$64.8m	$66.1m

$10,000 invested in Clime Capital vs LIC and Accumulation Indices



Data Sources: Thomson Reuters; IRESS

Portfolio - 30 Sept 2012



Portfolio turnover remained low and asset allocation consistent over the quarter.

The holding in BHP Billiton was marginally increased as attractive pricing presented during the quarter.

Bank holdings (ANZ Banking Group, Commonwealth Bank & Westpac Banking Corporation) were maintained over the quarter however grew as portfolio positions due to strong performances. CBA reported a sound full year result and paid a healthy franked dividend. Our bank holdings, acquired at meaningful discounts to our valuations, today trade at slim margins to increased valuations. Our enthusiasm for buying banks is low however we are content holders of quality local banks.

The holding in Brickworks Limited was maintained and the Reece Australia Limited holding was increased as attractive pricing and volume became available toward the end of the quarter.

New holdings in Fleetwood Corporation, Lycopodium Limited and Monadelphous Group were added late in the quarter as these high quality businesses became attractively priced due to poor sentiment developing in the sector. The Mineral Resources holding was increased as attractive prices presented in early September.

The holding in Ethane Pipeline was meaningfully reduced as the forecast distribution for this entity was reduced.

The Reject Shop holding was maintained however the portfolio position increased markedly as the business reported a strong full year result and the market responded by rerating the share price significantly. This business has a strong financial footing post the Queensland flood disruption and we are optimistic about its future prospects.

The Blackmores holding was liquidated due to a swift share price appreciation in advance of our valuation. This holding represented an unusually short time period from purchase at a 10%+ discount to our appraised value to a sale at 15% premium to our valuation. Whilst we do not set out to be as active occasionally such opportunities will warrant action as we view expensive prices relative to our valuations as presenting undesirable risk.

The IRESS Limited & Telstra Corporation Limited holdings were reduced marginally due to prices trading in excess of our valuations. These businesses continue to attract us to their reoccurring revenue streams and yield in the current low growth environment.

The McMillan Shakespeare holding was reduced as the business traded close to our forecast 2013 valuation and we took the decision to reduce our desired portfolio position. We are continuously alert to our responsibility of managing the portfolio and have self imposed limits for position weights to maintain sound risk management. Our conviction in the business and management remain.

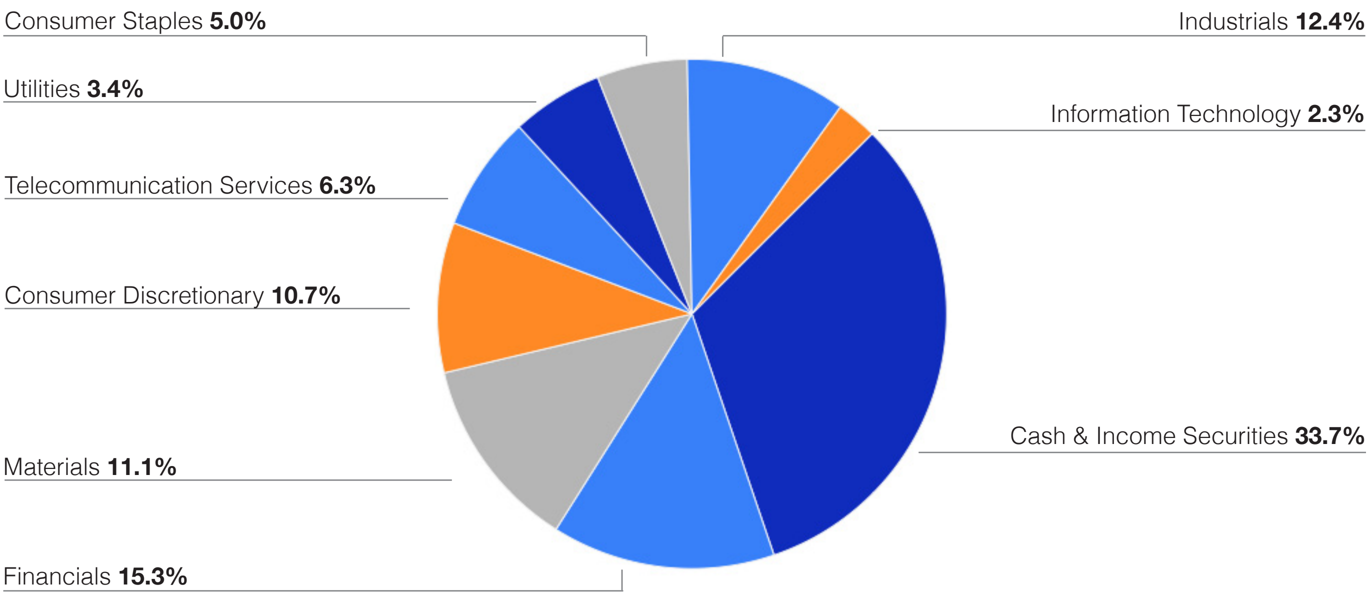
The OrotonGroup holding was maintained over the quarter as the business announced its exclusive Ralph Lauren license is to expire in June 2013. The business reported solid full year results and we look forward to management's revised strategic focus.

At quarter's end we are actively purchasing a new holding in a diversified financial group that attracts on solid reoccurring revenue. We will share this in the next quarterly update.

As at the 30th September Clime holds a meaningful cash reserve in anticipation of continued opportunity however the lower cash rate has reduced the relative attractiveness of holding cash and equivalents. Over the longer term cash is likely to be a poor investment and the intention is to become more invested as attractively priced opportunities present.

Top 15 Holdings	Weightings
BHP Billiton Limited	6.92%
Telstra Corporation Limited	6.28%
McMillan Shakespeare Limited	5.81%
ANZ Banking Group Limited	5.49%
Multiplex SITES Trust	5.25%
Woolworths Limited	5.00%
Westpac Banking Corporation	4.69%
Brickworks Limited	4.22%
Commonwealth Bank of Australia	4.06%
Australand ASSETS Trust	3.95%
The Reject Shop Limited	3.66%
Ethane Pipeline Income Fund	3.39%
Seven Group Holdings Preference Security	3.11%
OrotonGroup Limited	2.77%
Thorn Group Limited	2.28%
Cash & Equivalents	**17.6%**
Total	**84.47%**

Sector Allocation



Market Outlook

We view it as remarkable that today while the RBA cash rate is close to 50 years lows and likely to head lower, the Australian dollar remains at elevated levels. This highlights the challenging and distorted global macroeconomic environment at present which is considerably influenced by excessive debt and currency debasement. This observation is starker when we observe the trade deficit is meaningful and commodity prices remain under pressure as the supply response gathers pace and Chinese growth slows. Our view is there is pressure on the currency however we do not expect the AUD to fall precipitously due to Australia's relative global attractiveness.

Lower interest rates and a weaker currency are a significant stimulus for the Australian economy and corporate earnings. Both are important for sound equity market returns. This is evidenced by the stronger US share market experience over recent years in the face of weaker economic conditions relative to Australia. Interest rates and the currency are akin to economic gravity for economies & equity markets. It is important to remember equity markets do not move in sync with economic conditions. Our conservative asset allocation remains little changed of late however is the subject of considerable thought at present as we position our portfolio toward where the returns are going to be rather than where they were.

The Chinese economy appears to have slowed swifter and deeper than many were expecting, potentially even the Chinese government. As Australia's largest trading partner a view on China's progress is important to our investing. This slowdown has had a significant impact on commodity prices which have been reflected in earning expectations and share prices for many companies, particularly businesses based in resource rich Western Australia. Most expectations are around 7-7.5%, still a strong real rate of growth. This is a self imposed slowdown to reduce inflation and the Chinese government have numerous levers available to stimulate growth. There is large debate around the unbalanced nature of GDP and pending leadership change. We should also be cognisant that a centrally planned economy has significantly different options at the government's disposal to stimulate as it sees fit in stark contrast to more private enterprise based western economies. The political response so far has been muted, no doubt influenced by the pending change in leadership.

Our view of the mining boom, like all cycles was always likely to have three distinct parts:

i. The commodity price surge (finished);

ii. The capital expenditure boom that higher prices attract (tapering off);

iii. The volume boom resulting from mine expansions (starting).

Looking across a broad suite of metrics from industrial production, exports, retail sales, electricity consumption, PMI & auto sales this slowdown appears rather benign relative to the 2008/9 experience. We do view positively China's continuing trade surplus, below trend inflation rate, fiscal surplus, relatively low government debt to GDP (~18%), low unemployment and low banking system non-performing loans which are estimated at 1.28% of gross loans (PwC), Australian non-performing loans are estimated at 1.8% for the majors and greater than 3% for the regional banks (APRA).

While China does have its challenges we believe commodity demand growth will slow however we see it continuing to grow as urbanisation and industrialisation continues. Our favoured holdings, Fleetwood Corporation, Mineral Resources Limited and BHP Billiton have significant reoccurring cash flows, strong financials and attractive prices.

In the US there are a number of areas of uncertainty such as the pending election and so called fiscal cliff. Unconventional open-ended quantitative easing is likely to add around half a trillion new dollars a year until unemployment improves. Positively the US economy has been creating jobs, just not fast enough to have a meaningful impact. The headline unemployment rate has improved however this has been influenced by a reduction in the participation rate. The housing market is showing some signs of improvement, which will via the wealth effect, improve sentiment and second order effects through out the economy. We expect this to be slow however a recovering US is good news for the Chinese economy as the US consumes around 20% of Chinese exports and thus a positive for commodity demand.

In Europe several developments that are positive for stability occurred during the quarter. Specifically these are the ECB's Outright Monetary Transactions facility and the German Constitutional courts ratification. These developments do not remove the growth, debt and unemployment troubles. They are likely to have removed the worst case scenario of a Euro wide breakup at the expense of an increased probability of inflation over time. With debt levels extreme, growth and inflation are unlikely to resolve the solvency problems. We do view multiple debt restructurings and the exit of Greece as probable however these are likely to have a lower destabilising effect on the global economy. To some degree the very poor sentiment is abating and we expect this to continue although not in a linear fashion.

Our view is that the local building cycle has likely bottomed however recovery is expected to be a slow affair extending over several years. A number of recent state based housing stimulus measures combined with lower interest rates are increasing affordability and quite recently nationwide housing prices. Our holdings in two strong businesses in the sector, Reece Australia Limited & Brickworks Limited are well positioned to provide sound performances. Our view with cyclical businesses is to be attracted to the strongest in the sector toward the bottom of the cycle when they are available at attractive prices. Often businesses with this type of characteristic invest during the downturn and take market share from weaker players which then becomes evident in increasing returns when the cycle turns. Both Reece and Brickworks have shown these characteristics recently.

Pricing of the banks funding has improved however consumers are sensibly wary of significant debt. While this is a negative with regards to credit growth it is a meaningful positive with regards to credit quality as noted by a reduction of loans in arrears. For our three favoured bank holdings, we are expecting gross pre-tax returns of greater than 12% for the next couple of years after 20%+ recent returns as the share prices appreciated meaningfully catching up with our appraised valuations. Owning banks always provides areas of concern however we are broadly comfortable with the outlook for the sector and keep a watchful eye on leading indicators of employment.

Retail sales growth remains subdued and interest rate cuts will help however we view it as too early to get excited about a broad uptick in consumer spending due to sub par consumer confidence and consumers propensity to save a healthy part of disposable income. We continue to look for sound results from our holdings that operate in niche areas, The Reject Shop and Thorn Group. We remain cautious around the outlook for the major department stores.

We do not view the equity market as significantly mispriced at present and continue to focus on seeking fundamentally strong businesses that are trading at discounts to our appraised valuations.

The current environment does encourage Clime to be cautiously optimistic for satisfactory returns from equities in the year ahead.

In conclusion we thank you for your continued support of Clime Capital and the entrustment of your investment capital with us. Should you wish to discuss any of the above please do not hesitate to contact us.

Kind Regards,
John Abernethy, *Chairman*
George Whitehouse, *Portfolio Manager*

About Clime Capital Limited

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Clime Capital Limited (ASX:CAM) was listed on the ASX in February 2004 to provide investors with the opportunity to participate in a long-term approach to portfolio investing using value investing principles.

The company's investment objective is to generate returns for shareholders by investing in businesses with understandable economics and excellent growth and income potential that are run by capable management.

The company was formed to provide access for all investors to a strategy intended to create long-term wealth by purchasing, at rational prices, a portfolio of businesses whose earnings are expected to increase over the years.

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