Clime Capital Limited (ASX:CAM)

Quarterly Report

June 2014

www.climecapital.com.au

Dear Fellow Shareholder,

The June quarter that was just completed continued a market trend that commenced in September of 2013. That trend can best be described as a rudderless sideways movement. It was a market that was trapped by low interest rates created by international monetary policy and a low growth Australian economy.

When market prices filter as expensive then prices will generally do one of two things. There could either be a market price correction that takes prices back to about fair value. Alternatively prices can move sideways (with some volatility) and essentially wait for value to lift towards the market price.

In my view the last nine months in particular and more generally over the last fifteen months, the market has been held at a fairly elevated level (when compared to value) by historically low interest rates. Australia's low interest rates are a result of offshore Central Bank activities that have acted like a pincer on both equity prices and bond yields. The relentless activities of Central Banks have snuffed out concerns with risk and left equity prices floating on yield. The good news is that the value of Australian equities has lifted and sporadic value has appeared and the manager has accessed a few value opportunities.

The activities of Central Banks make it difficult to confidently predict the short term direction of markets. There is so much interference in asset pricing and so little real growth that a re-rating of Australian equity prices based on economic performance is hard to perceive. Rather it will be an exogenous event that will stimulate Australian equity prices. The most likely event is a depreciation of the $A from its current lofty heights. However, the timing and extent of depreciation is obviously dependent upon many uncertain occurrences in major offshore economies.

The likely fall at some point in the $A is being factored into the equity selection of the company – both in its onshore analysis and its review of offshore equity opportunities. Indeed there seems 3 key predictable cycles that the company will continue to focus upon. These are:

- The likelihood of a depreciating $A and its effect on the economy and certain industries;
- The certainty of continue 1.5% population and therefore consumption growth in Australia; and
- The unstoppable emergence of the Chinese consumer class.

Kind Regards,

John Abernethy
Chairman

In this issue

The Clime Capital offer to shareholders

Clime Capital Limited ("Clime") offers investors the opportunity to invest in a value focused "closed end" Listed Investment Company managed by a recognised top performing 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;
- 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 & International 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 absolute 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 (as at 30 June 2014)	$0.97
Rolling 12 Month Dividend	4.3cps
Historical Dividend Yield	4.4%
Percentage Franked	100%
Grossed Up Yield	6.3%
Dividend Reinvestment Plan	Yes

Preference Shares Overview (ASX:CAMPA)

Share Price (as at 30 June 2014)	$2.12
Rolling 12 Month Dividend	19cps
Historical Dividend Yield	9.0%
Percentage Franked	100%
Grossed Up Yield	12.8%
Dividend Reinvestment Plan	No

Converting Preference shareholders will accrue the bonus issue and upon conversion will receive 1.387 Ordinary Shares for every Converting Preference Share. Converting Preference shares will convert to Ordinary shares on 30 April 2017.

Outlook and Market Commentary

Interest rates locally & globally are likely to remain low for some time, in real terms interest rates are negative in much of the developed world. The clearest effect of low interest rates is in asset pricing locally and particularly globally, on this basis there is not a developed equity market trading at an attractive price. The forward return potential of the Australian equity market is in the 7% range from a fundamental view point. The elevated asset pricing is being accompanied by historically low volatility in equity & currency markets. Economic growth both locally and globally is relatively poor, given the remarkable monetary settings and presently inflation is not a concern. Many investors are finding the path of least resistance is to own significant equity holdings, following the crowd does not lead to enduring success. We maintain our discipline to focus on absolute returns for shareholders and balance maintaining capital with growing capital. We are seeing opportunity and have added several new investments to the portfolio in recent months however broad based opportunity is lacking.

We have noticed more recently a trend by some analysts & investors that appears to be the mispricing of risk. At the core of this observation is a tendency to reduce the discount rate or required return in the valuation process. While one can understand the pressures on sell side analysts to have 'buy' calls at all times, it is interesting to observe this theme permeating the buy side. It is the buy side that holds the fiduciary duty for clients & shareholders and arguably should know better. By way of example Westpac Bank today has a forward valuation of around $32 based on a discount rate of 11.5%. We view 11.5% a fair return (income & capital) for holding the equity of the bank given the risks & rewards that are involved in operating a bank. If one was to simply compromise their discipline and require a 9% return for holding the equity of the bank, a valuation of $44 would ensue. We have been active in recent months selling Westpac equity at prices around $35.50 - $36 as in our view the price was excessive relative to our valuation and the forward return potential was compressed. It is important to note that this view and activity is relative to the goal of achieving absolute returns for shareholders rather than following the herd in a race to the bottom on discount rates. History shows that when risk is mispriced unpleasant outcomes often follow. We think a little complacency is creeping into the consensus valuations of the day. We focus on getting an appropriate reward for the risk we are subjecting shareholders capital too, our advantage here is our fundamental view, absolute return focus and disciplined execution of our process.

Our competitive edge in markets is our people and our process. Our process is designed to protect on the downside and capture the upside. Our long term returns show these two important components are working well. Our focus points are fundamentals and forward return potential. The most attractive risk adjusted returns are often found in areas where many investors feel uncomfortable, this is where mispricing & opportunity exists.

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

Kind Regards,

George Whitehouse
Portfolio Manager

Performance

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

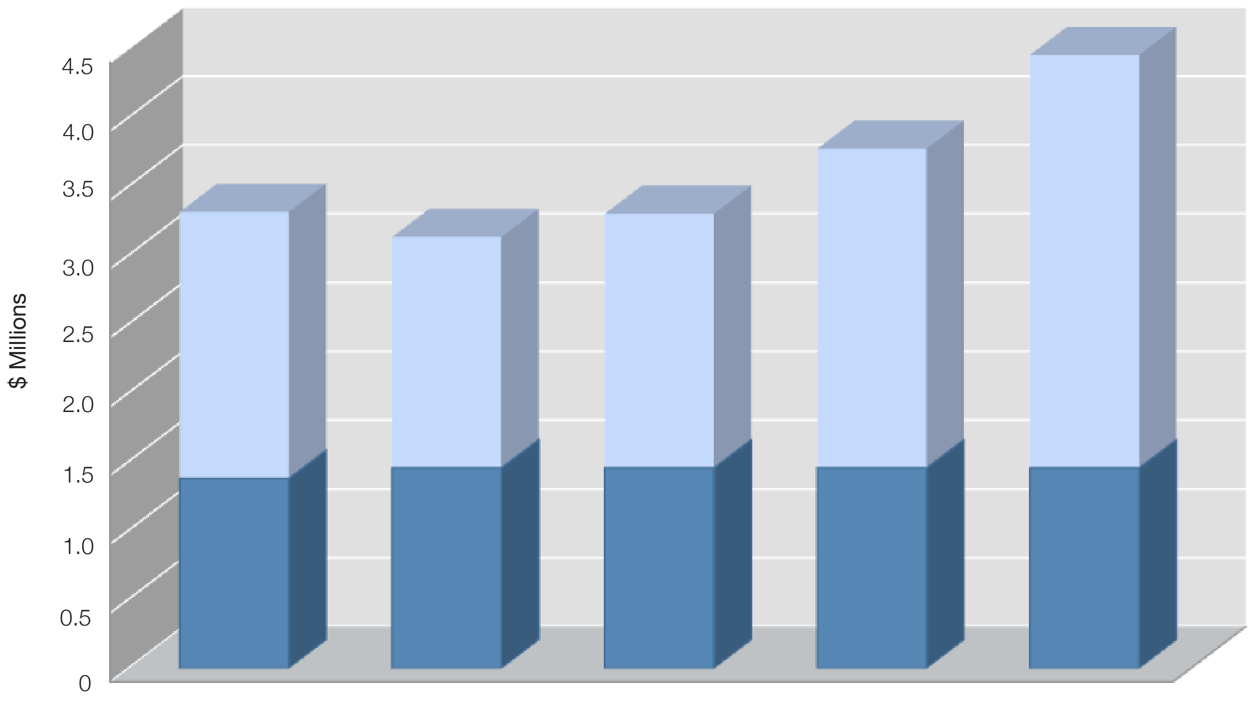
As at 30 June 2014	1 Year	3 Years	5 Years
Clime Capital Total Shareholder Returns	1.2%	7.7% p.a.	16.6% p.a.
Actual Total Returns		24.9%	115.2%

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 and payment of preference dividends.

More recently and despite market volatility, the Manager has ensured that Clime's capital has been maintained along with the payment of regular quarterly franked dividends to both ordinary and preference shareholders.

Total Dividends Paid or provided for (including Preference Shares)

July 2009 to June 2014



	2010	2011	2012	2013	2014
Ordinary Dividends	1.94	1.68	1.85	2.32	3.00
Preference Dividends	1.38	1.46	1.46	1.46	1.46

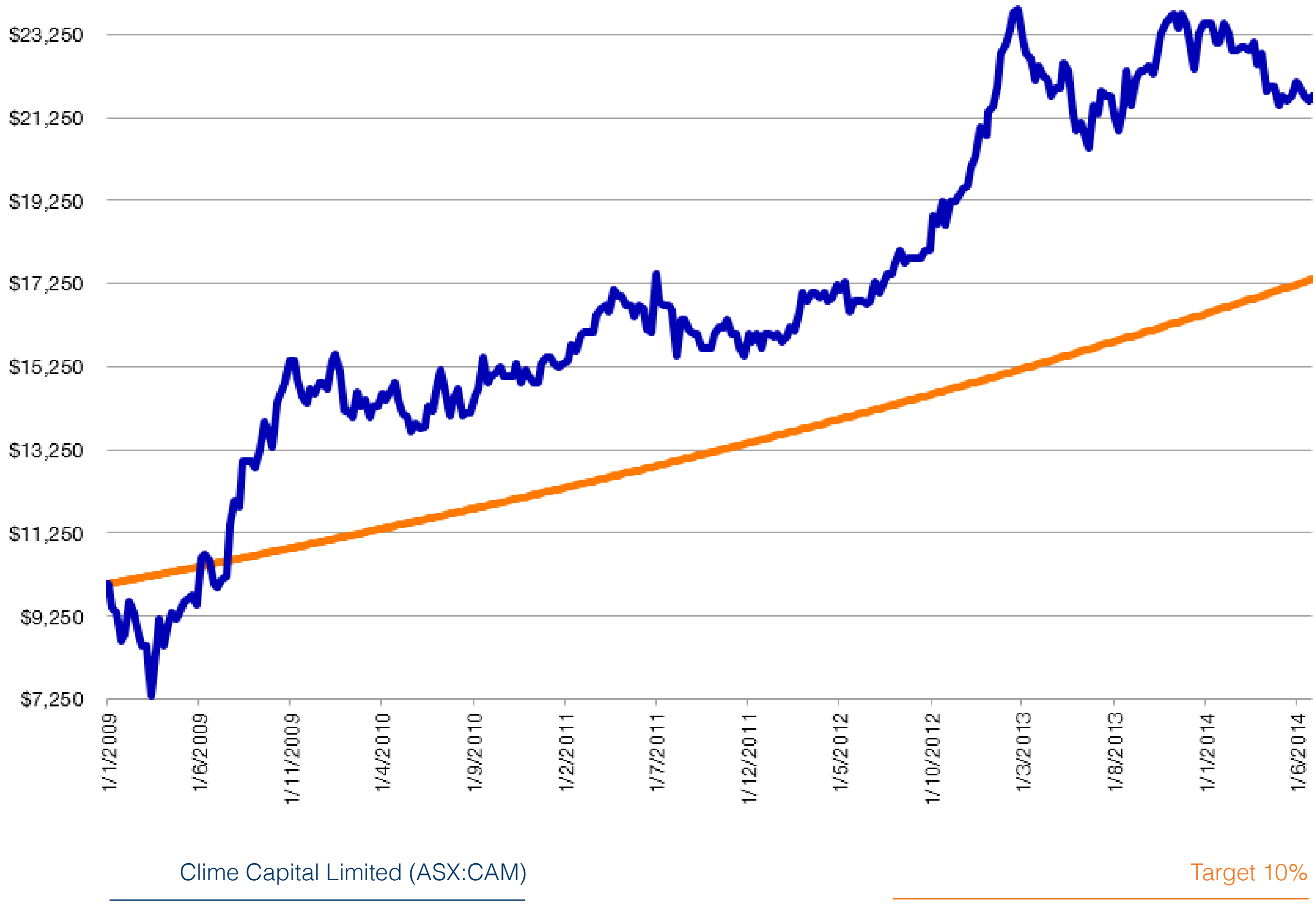
Portfolio Summary at 30 June 2014

Investments ($m)

Investments	Jun '14	May '14	Apr '14	Mar '14	Feb '14	Jan '14
Listed Securities	$57.9	$57.4	$54.5	$55.4	$56.6	$53.5
Cash	$36.9	$39.8	$43.0	$42.1	$30.5	$32.4
Net Assets	$94.8*	$97.2	$97.5	$97.5	$87.1	$85.9

** After accruing payment of June Quarter dividends ($1.3m).*

Year Shareholder Returns: $10,000 (January 2009 to June 2014)



Data Source: Thomson Reuters

Early in the period the investment in Australand Convertible Notes was liquidated as pricing close to par presented. The investments in Multiplex Convertible Notes & Seven Group Holding Convertible Notes were maintained over the period while Macquarie & National Australia Bank Notes were increased. The latter has provided equity type returns with debt type characteristics and continues to offer a sound forward return profile.

The investment in BHP Billiton was reduced during the period reflecting a moderating view on the iron ore market. Over the past year, our view on the outlook for iron ore pricing has moderated meaningfully, reflecting a view that the demand side risks are increasing at a time when supply is increasing significantly. This view has partly been reflected in iron ore pricing recently.

Six months ago we liquidated NWH Holdings and Mineral Resources both at significant profits, around valuations and well above current pricing. This is one example of our team working to implement the impacts of our macroeconomic views into portfolio actions. Whilst reduced within the portfolio, BHP is among the few ASX investment grade listed resource producers. With a neutral to moderately bearish view on iron ore, the second order effects on the local economy and currency cannot be ignored. On this front our work is ongoing but we have progressively reduced the banking sector investment as prices reflect perpetual economic strength and banks resilience, via provisioning, appears to be weakening. Banking investments have fallen from around 20% of the portfolio 12 months ago to around 7.5% today.

The Westpac investment was reduced by one third during the period as elevated pricing presented while the ANZ investment was maintained. Call options have been sold over part of the Westpac investment.

The investment in Brickworks was maintained, volumes are increasing and Brickworks appears to have reasonable tailwinds at present, much of this is priced in and we expect sound performance over the longer term via strong management executing the strategy. Adelaide Brighton was added to the portfolio following a new CEO taking the reins with the typical first year of ‘restructuring’ and softer earnings outcomes which knocked the price below fair value and opened up a margin of safety. This reduced the risk and increased the return potential. This business has a formidable competitive position in key markets, sound management and a history of sensible capital management. There is an elevated possibility of several special dividends and sound capital growth underlying our double digit TSR expectations over the medium term. The most prominent risk to our thesis is a weaker local GDP outcome where revenue correlation to GDP is very strong. The more bullish outcome is the much talked of infrastructure spend touted by both state and federal governments.

The Reject Shop investment was increased over the period as market pricing became more attractive. We are attracted to a sound business model that has been tested by over thirty years of operation. We hold a medium term view that this business, driven by good management and sound execution, will be able to earn similar profits per store that it has in the past as it enjoys the benefits of scale, fractionalising fixed costs over larger sales volumes with the infrastructure costs now sunk. This is the core investment proposition and our time frame is 2 - 4 years for this to become evident in the accounts. This will require sound execution. Execution is the key risk with this investment. The board has appointed a new CEO. With a key competitor entering receivership for the second time in the last two years the opportunity for earnings growth is significant.

The investment in Austal Limited was liquidated toward the end of the period as the price appreciated to our view on value. Management appears to be executing on the strategy and margin expansion within the US operations is on track. The investment thesis was recognised by the market swifter than we anticipated on purchase, pleasant but unforeseeable. Our investment time frame is the medium term. The risk of a sound investment outcome has increased as the price has re-rated, thus our appetite for maintaining the investment has decreased.

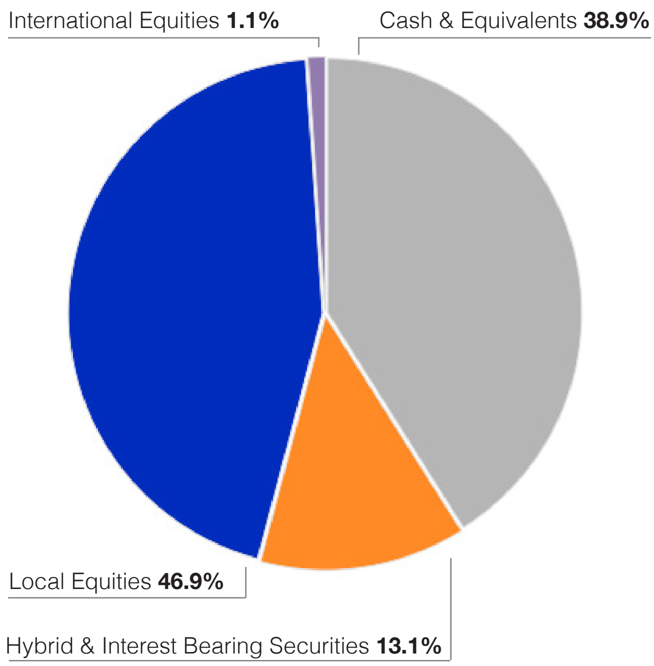
The investment in SMS Management was increased during the period. Activity levels are increasing however from a low base. Management to their credit have appreciated the cyclical nature of their business and commenced a buyback at what is increasingly looking like a cyclical low. It is highly likely that this will be reflected upon in years to come as very good capital management. Businesses should always consider all capital management options, organic growth, dividends, acquisitions & buy backs. When more value can be created for shareholders via the repurchases of shares management should have the courage to execute, the board & management have made a sound decision that will significantly accelerate EPS growth as the cycle turns.

Initial investment was made in New Hope Corporation. New Hope is an efficiently run coal miner who has a sound structure of owning both the port and the mines. Half the market capitalisation is in cash giving the board & management remarkable flexibility to pursue sensible capital management at an opportune part of the cycle. The business has the franking ability to pay more than $1B of franked dividends, it is likely the board and management will consider all capital management options and weight the longer term benefits to shareholders. The commodity price has been under significant pressure for some time which is reducing near term earnings and creating the medium term investment opportunity. In the medium term we look to improving coal prices from rising demand in Asia and a rising US gas price moderating US coal supply from the seaborne market. We are confident management will keep costs under control and have a medium term view of local currency weakness. These catalysts are the value drivers of tomorrow and core to our investment view.

An initial investment was made in the US listed ADR of Gazprom OAO. Gazprom is domiciled in Russia and has diverse portfolio of assets across gas, gas transportation and storage, oil and electricity. For example, Gazprom has 18% of the world's gas reserves, over 168,300km of gas transportation pipelines, 1,200 MMToe of oil reserves and 62GW of generation capacity (Australia's total is around 45GW). Despite its enduring earning capability, Gazprom trades at a fraction of the multiples of Exxon and its other global peers, with a price to book of 0.3 and a PE of 4 (Exxon at 2.5 times book value & 13 times forward earnings). While closing of the valuation gap to international peers is unlikely in the near term significant fundamental value is on offer along with a free currency option stemming from a depressed Russian Rouble and elevated AUD relative to the USD. The quality of the assets and the attractive entry price offset the geopolitical risks involved with investing in the region and create significant forward return potential.

As at the 30th June Clime holds a meaningful cash reserve, in anticipation of continued opportunity both locally & internationally.

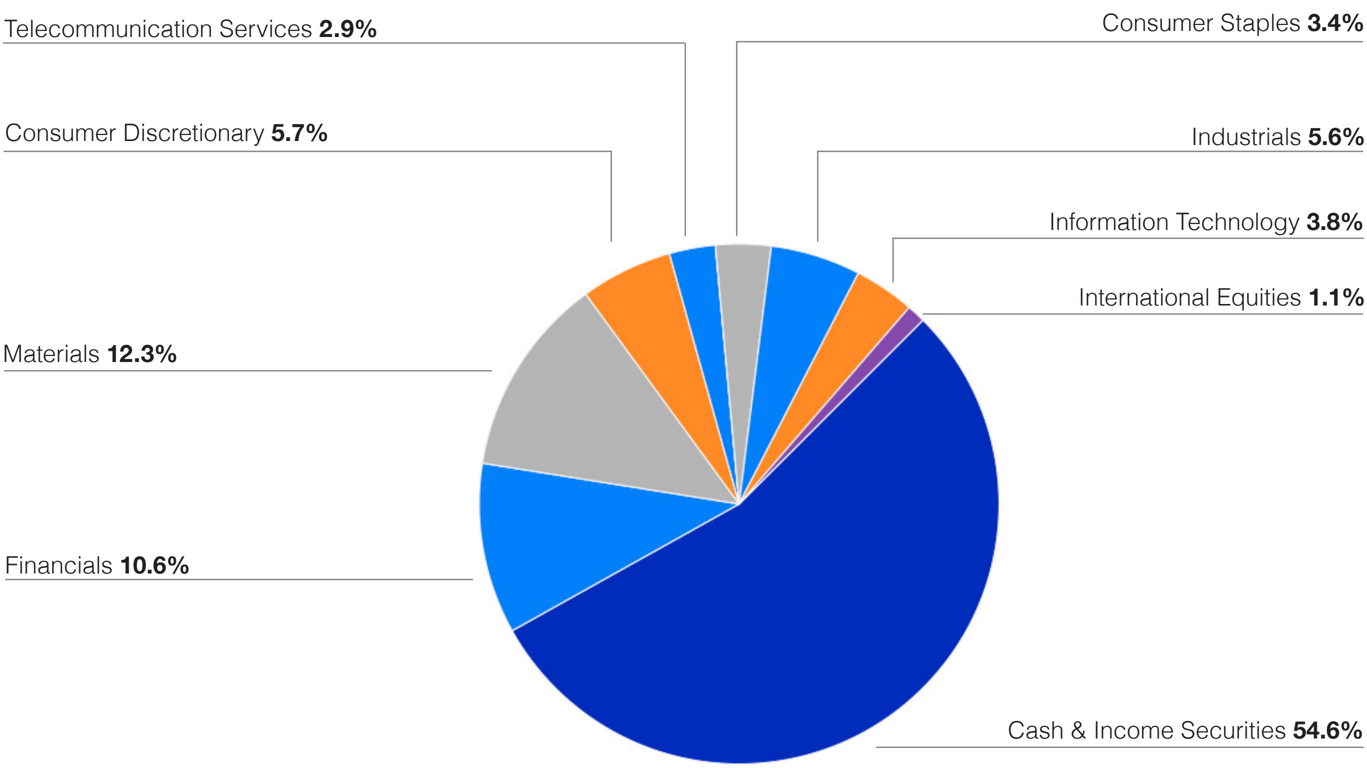
Asset Allocation



Top 10 Holdings

	Weightings (%)
BHP Billiton Limited	5.58
Australia & New Zealand Banking Group Limited	5.20
Multiplex Convertible Note	4.08
Brickworks Limited	4.01
SMS Management & Technology Limited	3.83
Macquarie Perpetual Notes	3.68
National Australia Bank Notes	3.65
Woolworths Limited	3.49
The Reject Shop Limited	3.18
Telstra Corporation Limited	2.91
Cash & Equivalents	*38.92*
Total	78.53

Sector Allocation



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. Holdings are reduced or liquidated 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

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 judgment and calculation.

The investment process applies a consistent valuation methodology to identify companies that have attractive investment characteristics. The process calculates a valuation for the company and identifies those companies whose share price is below the 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.

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

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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