Ellerston Capital

Ellerston Overlay ASF

PERFORMANCE REPORT February 2018

The investment objective of the Ellerston Overlay ASF (Fund) is to provide investors with a return that outperforms the S&P/ASX200 Accumulation over time. The Fund aims to achieve this by investing in a concentrated portfolio comprising of no more than 30 Australian listed securities and where possible, enhancing income through the use of Derivatives and shorter term trading strategies. The Fund aims to be invested with a minimum of 90% in physical securities at all times and must maintain a net exposure of 50% or greater. At least 75% of the Fund will be aligned to the portfolio of the Ellerston Australian Share Fund (EASF).

Ellerston Overlay ASF Performance

	Gross	Benchmark	Excess	Net
1 Month	-0.19%	0.36%	-0.55%	-0.22%
3 Months	3.33%	1.72%	1.61%	3.02%
FYTD	8.61%	8.27%	0.34%	7.86%
Rolling 12 Months	14.49%	10.10%	4.39%	13.34%
2 Years (p.a.)	18.09%	15.96%	2.13%	17.14%
3 Years (p.a.)	8.01%	5.07%	2.94%	7.03%
5 Years (p.a.)	9.20%	8.01%	1.19%	8.13%
Since Inception (p.a.) 4 Jan 2012	12.81%	11.29%	1.52%	11.65%
Since Inception (CUM)	110.30%	93.38%	16.92%	97.26%

Returns are calculated using the Fund's redemption price and are net of fees and expenses. Returns are also calculated on the basis that distributions are reinvested.
Returns of the Fund may include audited and un-audited results.
The benchmark is the S&P/ASX200 Accumulation Index. Past performance is not a reliable indicator of future performance.
Since Inception is 4 January 2012.

Market Commentary

Global Market Overview

In February, volatility was back with a vengeance. Equity markets around the world ended the month in the red, with significant intra-month fluctuations. Early in the period, a sudden futures related technical sell-off hit global stock markets, amid concerns over rising inflation and rising interest rates. The VIX index, which measures volatility, saw the sharpest one-day spike in its history. The spike was exacerbated by the so-called “target volatility funds” that scrambled to sell stocks and buy VIX options. US equity markets led the weakness and the yield on US 10-year bonds hit a high of 2.95%. Inflationary concerns and stretched equity valuations weighed on investor sentiment. European and Asian markets were not spared and also ended the month in negative territory.

USA

After logging its strongest January since 1987, the S&P 500 index and the Dow Jones Industrial Average index ended February down 3.7% and -2.6% respectively. Considering the underlying fundamental strength of the US economy and better-than-forecast corporate profit reports, a number of several hundred point swings in the Dow Jones caught many investors unawares. Optimism over the effect of the Trump corporate tax cuts on earnings quickly gave way to concerns over rising inflation and interest rates. Some commentators believe that the fiscal stimulus from the tax cuts could be inflationary given the underlying strength of the economy and tight labour market. Towards the end of the month, the new Chairman of the Federal Reserve, Jerome Powell, provided a bullish assessment of the US economic outlook, but hinted clearly that the Fed could step up the pace of rate rises. This forced a rethink that perhaps the market was getting ahead of itself and was too sanguine on inflation and valuations. Four rate hikes are now expected by the Fed in 2018.

The US dollar was stronger against a basket of currencies, buoyed by the prospect of higher rates. Following Chairman Powell’s hawkish congressional testimony, the dollar index touched a five-week high, maintaining its upward momentum.

Early March saw Wall Street fail to gain ground as the prospects of inflation and interest rate rises, downward revisions to fourth-quarter US GDP, weaker Chinese PMI numbers and a likely trade war stifled positive sentiment.

Europe

European markets were sluggish across the board. The weakness in the US and similar fears about stronger inflation and higher rates pulled markets lower, with the UK’s FTSE 100 down 3.4%, Germany’s Dax down 5.7% and the French market down 2.9%. Politically, it was heartening that a deal was struck in Germany for a coalition government to be formed, ending the political limbo. The Bank of England left rates on hold and the European Central Bank President indicated that the true amount of economic slack “could slow down the emergence of price pressures”, putting Europe slightly at odds with the commentary from the US.

Asia

Asian markets followed the US markets’ lead and were weaker in all major jurisdictions. Of the larger bourses, Japan closed down 4.4%, Hong Kong was down 5.6%, India lost 5.0% and the Shanghai B index lost 4.9%. Korean stocks lost 6.2%, the worst monthly decline since June 2013. While global fears of a pickup in inflation and the possibility of stretched valuations were to blame for the weaker performances, a disappointing Chinese official manufacturing PMI print in February also contributed. Chinese PMI dipped to 50.3 from 51.3 in January and was much weaker than consensus expectations of 51.1. This was the lowest reading since July 2016 and was enough to dampen growth expectations.

Commodities

Commodity prices were generally weaker in February with oil going from being one of the best performing commodities in January to being one of the worst performing, ending the month down 4.8% to US$61.60 a barrel. Data released in February indicated that US oil production surged to an all-time high in November, with US producers pumping just over 10 million barrels a day. Gold fell 2% in February, after a volatile month’s trading.

Bonds

The month was characterised by Treasury yields continuing to nudge higher, with the US 10-year bond yields hitting 2.95% intra-month, but failing to crack the 3% level. Debate rages on the extent of the bond market correction, but the market now expects the Fed to raise rates more aggressively than it did last month.

Australia

The Australian market performed better than its global peers. **The S&P/ASX 200 Accumulation Index ended February up 0.4%.** The market traded in a wide 300 hundred-point range as global equity markets corrected. Of the sub-sectors, the ASX Accumulation 200 Industrials Index took line honours with a return of 0.6% while the ASX Accumulation 200 Resources Index took out the wooden spoon returning -0.7%. The Small Ords Accumulation Index delivered a flat return.

First the correction then the recovery: The ASX 200 entered the FY18 interim results season overshadowed by a global equity market correction, with major global equity indices falling by as much as 8% (in USD terms) through this period (31 January to 8 February). Domestically, the ASX 200 found its low on 12 February and at this point the index had fallen 3.6% since the start of the month. From these lows, the ASX 200 gained 4.1%, to close the month at 6016 pts, 0.4% higher than it started.

Guidance leads to more upgrades than downgrades: 166 companies reported full-year and interim results through February, representing 75% of the ASX 200 by market cap, with 43% of companies' consensus EPS for FY18 revised higher compared to 34% revised lower for an up/downgrade ratio of 1.2x. More importantly, where guidance was given, it led to 1.5x more upgrades than downgrades for FY18 consensus EPS, with 44% of companies' consensus EPS revised higher versus 30% revised lower. Sectors which had the largest positive EPS revisions (on weighted average basis) were Energy, Industrials, Tech and Health Care, whilst sectors with negative EPS revisions include Telecommunications, Financials and Materials.

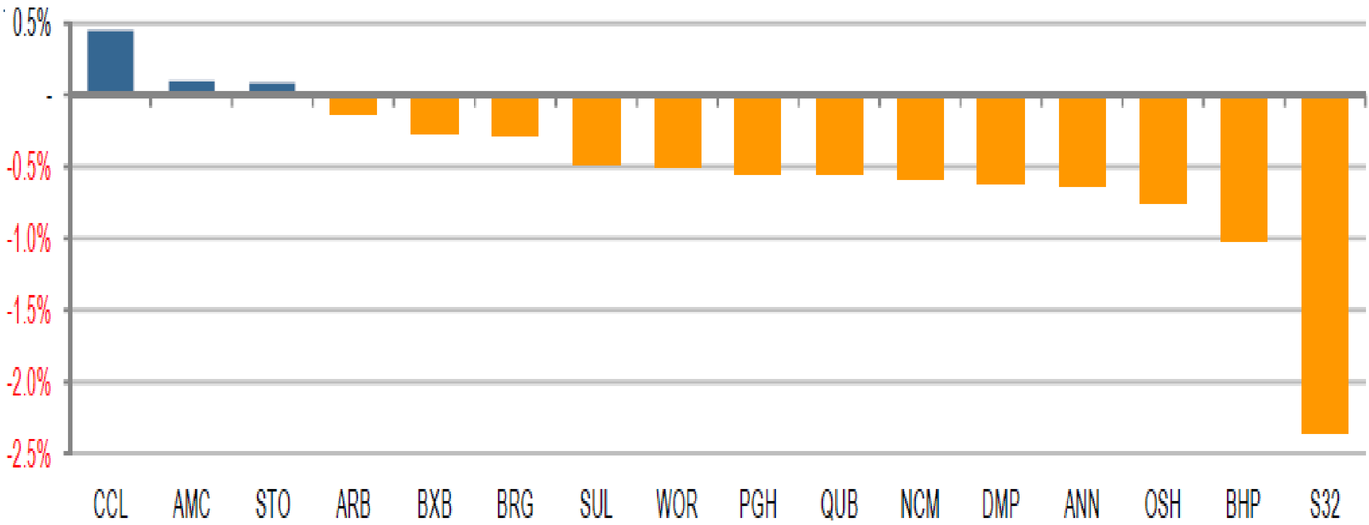
Upgrades rewarded: Companies with positive EPS revisions of greater than +1%, on average outperformed the ASX 200 by +2.3% on results day and continued to outperform post results announcement by +3.9%. Misses, however, were punished to the tune of -2.6% on results day and continued to retreat by 5.0% on average post results announcement.

With reasonable reported earnings growth and more companies than not reaffirming or slightly upgrading on full-year guidance, the "bottom up" consensus forecasts for the overall market were upgraded for FY18 and FY19. Following this reporting season in Australia, we would make the following observations:

- Results have on average been better than expectations, with the number of companies beating expectations exceeding the number of companies missing expectations.
- Companies are still returning cash to shareholders, with payout ratios edging higher, mostly due to upward surprises by resource companies and miners returning cash to shareholders at the expense of ramping up capex.
- Investors continue to reward high PE stocks, with growth and momentum stocks miraculously recouping most of their losses from the sell-off in early February, while value stocks lagged.
- Top-line growth expectations continue to be positive, but margin expectations have been trimmed partly because they were already high and some companies are reporting cost pressures.
- Cost pressures have started to materialise, especially in the Materials and Energy sectors.

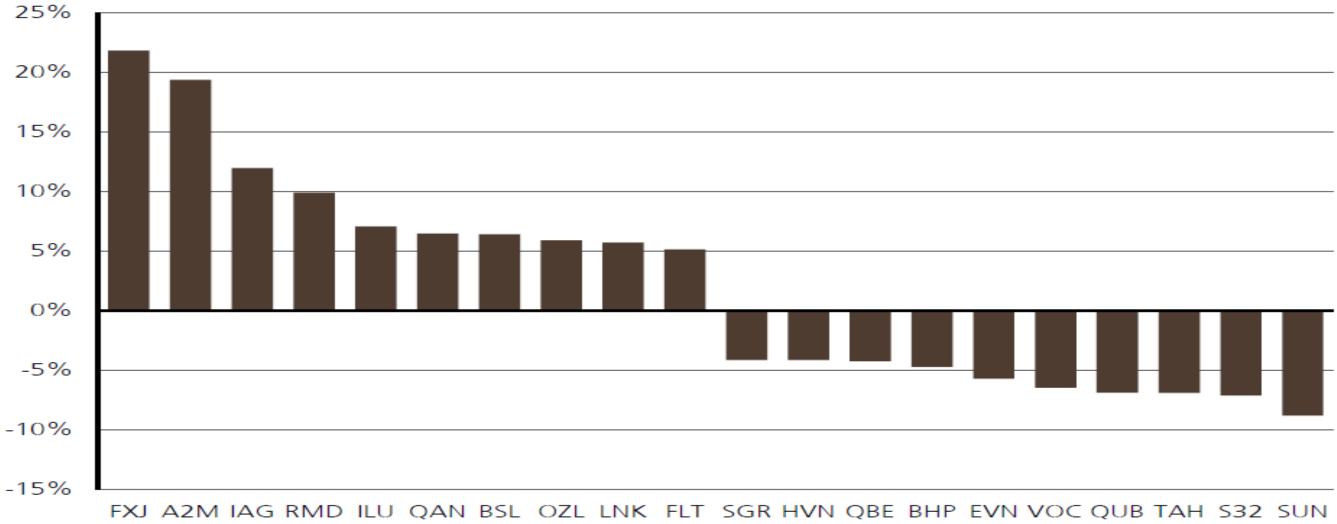
See the chart below that sets out EBITDA margin forecast revisions for key companies that have pointed to higher costs.

EBITDA Margin change by stock



Source: JP Morgan estimates, Bloomberg.

The chart below shows the 10 largest consensus EPS upgrades and downgrades in the ASX100.



Source: UBS, Factset.

The best performing sectors were Health Care (+7.0%, led by CSL which was up 11.4% and Primary Health Care up 9.9%), Consumer Staples (+1.1%, led by a2 Milk, up a staggering 47.5% after it upgraded earnings, and a strong rebound in performance from Graincorp, up 7.7%), and Information Technology (+0.9%, led once more by Altium, NEXTDC and Computershare after they all delivered solid results).

Rising bond yields hit interest rate sensitive sectors and weaker oil prices plagued the energy sector. Not surprisingly, the Telecommunication sector underperformed (-7.8%), led by Vocus Group down a whopping 18.1% after it cut its 2018 guidance, and Telstra down 8.7%, Energy (-4.6%), was dragged down by Woodside Petroleum slumping 10.9% after it announced its FY17 results, the acquisition of an additional 50% interest in Scarborough and an unexpected $2.5 billion equity raising, and Utilities (-2.9%). Financials also struggled, ending the month down 0.2%.

The stocks that added the most to the index in February were CSL (+26.5 points), National Australia Bank (+11.3 points), a2 Milk (+11.2 points), Insurance Australia (+10.3 points) and Australia and New Zealand Banking Group (+6.2 points). The main points detractors were Woodside Petroleum (-10.4 points), South 32 (-10.0 points), Wesfarmers (-6.3 points), Telstra Corporation (-6.3 points) and Commonwealth Bank (-4.5 points).

The Reserve Bank of Australia kept interest rates on hold in February, with the Governor warning that “one continuing source of uncertainty is the outlook for household consumption…household incomes are growing slowly and debt levels are high”.

Company Specific News

The Market Misses

BWX (BWX -34.0%)
BWX reported 1H18 Underlying NPAT up 32.1% to $10.8 million, but came in significantly below expectations. The miss was driven by much lower than forecast revenue, particularly in domestic Sukin sales, while EBITDA margins also surprised on the downside, primarily driven by higher marketing expenditure. BWX’s EBITDA guidance of $42-46 million for FY18 was below expectations, partly due to the impact of the company’s decision to discontinue third party manufacturing and distribution and focus on its core brands.

IPH Ltd (IPH -33.9%)
Earnings downgrades were severe for this intellectual property services firm in the wake of an earnings result that missed expectations across most key measures. Patent filings continued to decline in Australia and the Asian region failed to deliver on frothy growth expectations. Management are, of course, expecting growth rates in both Australia and Asia to rebound in the second half, as the adverse impact from US patent law changes fade. The market is understandably cautious given the recent disappointment.

Myer Holdings Ltd (MYR -31.3%)
Myer keeps finding ways to make a regular appearance in 'The Market Misses' and this month is no exception. A very weak trading update released to the market on 9 February highlighted a sales slump in December and January. 1H18 earnings guidance is now pointing to a fall of around 40% in NPAT towards $39 million. This was followed shortly by the news that CEO Richard Umbers would be standing aside. No replacement has been identified as yet and it would take a brave individual to step in at this junction, especially against the backdrop of veteran retailer Solomon Lew angling for radical change.

Wisetech Global (WTC -31.3%)
The risk of letting expectations get out of control were laid bare when market darling Wisetech delivered 33% growth in EBITDA, but below market estimates. Organic growth slowed rapidly and only multiple acquisitions over the last period allowed for FY18 guidance to be maintained. Whilst the sell-off was sharp, the company still trades on massive PE of greater than 70x and more staggering, an EV/Revenue multiple based on consensus numbers of circa 14x for FY18.

Platinum Asset Management (PTM -22.9%)
Platinum delivered 1H18 results largely in line with expectations, but news that founder and CEO, Kerr Neilson, was stepping down to take more of a mentoring role was obviously taken negatively with the stock closing down 12% on the day of the announcement. As seasoned investor Kerr Neilson is synonymous with Platinum, investors anticipate outflows and weaker performance going forward.

Vocus Group (VOC -18.1%)
Troubled telco Vocus found a new way to miss consensus, with 1H18 FCF conversion of 68% falling well short of its previous 85-90% target. This time it was the outlook statement, as opposed to the underlying results that disappointed, with guidance cut circa 10% at the NPAT line. Weakness in its core consumer division and higher depreciation drove the downgrades. The challenges of turning around Vocus in an extremely competitive market proved too much for CEO Geoff Horth, who announced his resignation.

Super Retail Group (SUL -19.9%)
Super Retail proved anything but super with its 1H18 results again disappointing the market. Both the Leisure and Sports divisions were extremely disappointing, the former hurt by the poorly performing Rays business unit. Operating EBIT fell circa 1.5% in 1H18 and early trading for the 2H got off to a weak start. The poor result was exacerbated by the announcement that Super Retail had acquired Macpac NZ from private equity at a lofty 9x EBITDA multiple and almost double the price paid by private equity only a few years back. With Super Retail trading at circa 5x EBITDA and a questionable history of executing on acquisitions, the transaction raised plenty of eyebrows.

Fletcher Building (FBU -15.1%)
Fletcher Building announced further provisions for expected losses in its Buildings + Interiors (B+I) division of NZ$467 million, culminating in total expected B+I FY18 projected losses of $592 million and a EBIT loss of NZ$660 million. This compares to previous guidance of a loss of NZ$160 million at the EBIT line. These provisions were the result of reviews under new CEO Ross Taylor and triggered a breach of Fletcher's financial covenants to its commercial banking syndicate and to its US Private Placement noteholders. The company received a waiver from the banking syndicate and the USPP noteholders (post month end), subject to conditions which the company expects to satisfy. As a consequence of this imbroglio, Chairman Sir Ralph Norris announced his decision to step down. The company reported an inline 1H18 result and confirmed previous guidance for EBIT (excluding B+I) to be in the range of NZ$680-720 million, but did not declare a dividend.

Domino's Pizza Enterprises (DMP -16.8%)
Domino's put itself firmly in the 2H club with an underwhelming 1H18 result up just 5% (weighed by weaker margins in Europe and Japan). Given its FY18 guidance of 20% growth (which it maintained), it suggests that an eye-watering 35% growth rate in 2H18 is required. The markets scepticism was further entrenched with the news that its talismanic CEO, Don Meij, had sold circa $18 million of his holding. A significant tax bill was proffered as a legitimate reason, but was somewhat lost in the conflict of selling whilst the buyback was apparently active.

South32 (S32 -13.1%)
South32 reported 1H18 earnings of US$544 million, modestly below consensus estimates. However cost inflation in its coal and alumina business and production downgrades largely at its troubled Cannington silver/lead/zinc operation, saw estimates for FY18 and FY19 cut aggressively.

Harvey Norman (HVN -11.3%)
Harvey Norman became a late entrant into the market misses with its 1H18 results reporting on the last day of the month. Missing at almost every level, frustration was further exacerbated by losses in Gerry's 'off-piste' investments requiring write-offs. With net debt higher, capital management seemingly pushed out and a dividend that disappointed, the market was in no mood to give Gerry the benefit of the doubt, with the stock down 13% on the day.

Woodside Petroleum (WPL -8.9%)
After the $3.5 billion sell-down from Shell in late November, the appetite of shareholders was further tested when Woodside announced an equity raising of $2.5 billion. Whilst a capital raising to acquire assets is fairly run of the mill, it was the magnitude that caught investors' by surprise. Woodside announced it will acquire Exxon's 50% stake in the Scarborough gas field for $560 million, with the other $2 billion earmarked for "future development", hardly compelling.

The Market Hits

a2 Milk Co/Bellamy's Australia (A2M +47.5/ BAL +21.6%)
After a strong run-up across January, on the back of upgraded earnings guidance, both a2 Milk and Bellamy's delivered with their 1H18 results and were rewarded handsomely. The demand from China for infant formula, as the burgeoning middle class soars in numbers, appears insatiable and is an undeniable thematic. a2 Milk's wide-ranging manufacturing and distribution strategic agreement with Fonterra also caught investors by surprise.

Altium (ALU +32.8%)
Altium, which develops electronic design automation for the Microsoft operating system, also continued its stunning run in February. Its 1H18 results saw revenue jump 30% and EBITDA lift 45%. Its Designer software experienced strong demand across most regions, with China again the standout. Solid long-term guidance of US$200 million revenue by FY20 and EBITDA margins greater than 35%, were enough to keep fans cheering.

Corporate Travel/Webjet/Flight Centre (CTD +25.7%/ WEB +16.1%/ FLT +13.3%)
Australia's three travel exposed resellers all produced the goods across reporting season, prompting consensus upgrades. Demand for international travel, particularly at the corporate level surprised on the upside and each platform shared in the spoils. Webjet combined strong demand for travel with its market leading online hotel offering.

Nine Entertainment/Seven West Media (NEC +35.7%/ SWM 11.5%)
After years in the doldrums, the television space proved that low expectations can truly be a driver of returns, at least in the short run. Better advertising revenues and reasonable cost controls drove the operating leverage that saw double-digit earnings upgrades across the board.

NEXTDC (NXT +17.0%)
NEXTDC reported strong results at every line of its operations, driven by huge demand for data storage from the major cloud operators. With Australia's most comprehensive and highest quality data centre offering, the company seems to be in the enviable position of being able to set prices and pass on any cost pressures.

GWA Group (GWA +17.5%)
GWA's 1HFY18 NPAT of $28 million was ahead of expectations largely due to market share gains in the Bathroom & Kitchens business and a stronger than expected result from Door & Access (NSW related). Management outlined that it expects 2H18 EBIT to be similar to 1H18 (sitting 4% ahead of consensus prior to the result). In addition, as a result of a recent strategic review, management has announced that the Door & Access business will be divested.

Costa Group CGC (+19.3%)
Despite some headwinds, CGC's 1H18 results showed significant momentum in profitability, with EBITDA margins up 140 basis points. The expansion in Produce margins boosted group earnings, despite the International business being loss making for the half. EBITDA grew 24% and was 6% better than market expectations.

Insurance Australia Group (IAG +15.3%)
Insurance Australia Group delivered earnings ahead of expectation and increased its guidance, now expecting further margin expansion (with a heavy skew to NZ driving the margin uplift). This has led to earnings upgrades and expectations of future capital returns. Insurance Australia Group is by no means cheap anymore and trades on over 19x FY19 consensus earnings, but is viewed as the quality stock in the insurance sector with lower volatility, good earnings momentum and a 5% yield.

Lend Lease (LLC +14.8%)
After warning about troubles in its construction division back in October, the market was pleasantly surprised with the company delivering 1H18 NPAT of $418 million, driven by the developments and investments divisions. This beat consensus by circa 8% and saw upgrades across this street. Adding to the enthusiasm, the company announced a buyback of $500m.

CSL (CSL+11.4%)
Market darling, CSL, delivered another strong set of earnings results, producing 11% revenue growth. It achieved healthy growth in its core blood products division despite cycling a period in which its key competitor had trouble supplying

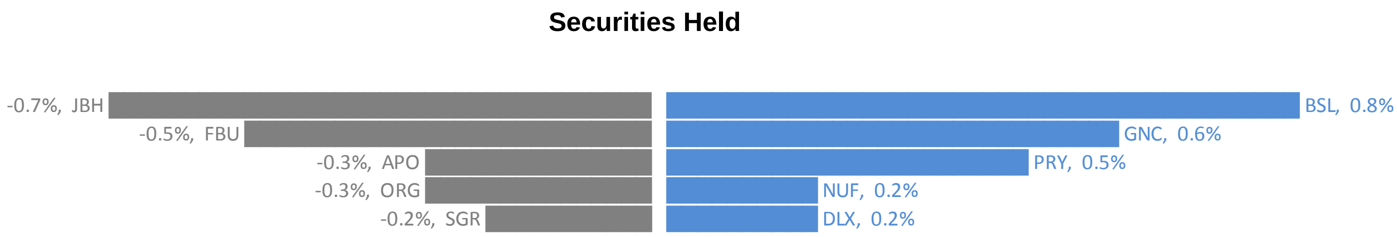
customers. Traditional use for its blood plasma derived products continues to grow, supplemented by product use extension into the treatment of other medical conditions and the rapid expansion of high margin specialty products. The unusually bad flu season this year supported demand for its flu vaccines which may normalise in future periods.

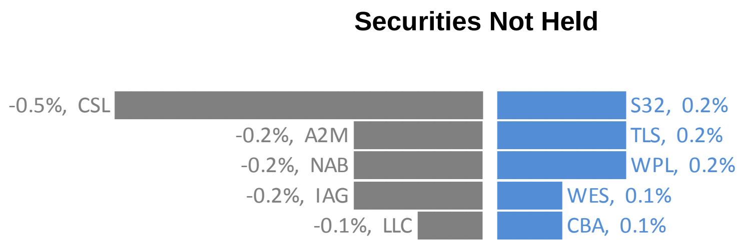
BlueScope Steel (BSL +12.6%)
BlueScope continued its strong run reporting 1H18 results some $50 million above the guidance given in mid-December. A very strong performance from its Australian Steel Products division drove the outperformance. BlueScope also guided for 25% growth in underlying EBIT in 2H18, or a touch above $600 million. Guidance was seen as conservative and with all eyes on President Trump and potential US tariffs on imported steel under Section 232 (a significant positive for BlueScope if enacted), further upgrades are likely.

Mayne Pharma Group (MYX +9.8%)
A decision by Warren Buffet's Berkshire Hathaway to take a meaningful stake in Teva Pharmaceuticals provided a boost to the whole pharmaceuticals sector, including Mayne. The generic drug industry has been plagued by price deflation in recent years, weighing on drug manufacturer share prices. Mayne's first half result certainly reflected the price deflation trend, with little sign that it will abate soon. Time will tell whether the Oracle of Omaha has picked the bottom in the drug pricing cycle or caught a falling knife.

Performance

Given the intra month volatility, the Funds return of -0.19% slightly trailed the benchmark return of 0.36% in the month of February. This brings the return for the FYTD to 8.61%, marginally higher than the benchmark.





The main contributors to this month's performance were overweight positions in BlueScope Steel (BSL +12.6%), Graincorp (GNC +7.7%), Primary Health Care (PRY +9.9%), Nufarm (NUF +3.9%) and DuluxGroup (DLX +5.2%)

The main detractors were overweights in JB Hi-Fi (JBH -8.4%), Fletcher Building (FBU -15.1%), APN Outdoor (APO - 6.11%), Origin Energy (ORG -3.1%) and Star Entertainment Group (SGR -11.0%) which underperformed the broader market.

Additionally, having a zero holding in CSL Limited (CSL +11.4%) had a negative effect on this months' comparative performance.

Activity

New stocks added	Stocks exited
▪ Tabcorp ▪ Suncorp Group	▪ BHP Billiton ▪ Star Entertainment Group

Strengthened positions	Decreases to positions
▪ Graincorp ▪ JB Hi-Fi ▪ Dulux Group ▪ Fletcher Building ▪ Nufarm	▪ Primary Health Care ▪ Rio Tinto ▪ AWE

Tabcorp Limited

During the month, we introduced **Tabcorp Limited (TAH)** to the Core portfolio post the recent successful merger of Tatts Group. TAH is an Australian based wagering and lottery provider with licences in all States except Western Australia.

The market view

TAH stock had a strong run up to $5.74 in the wake of final regulatory approval for the merger with Tatts Group in late 2017. It has since fallen back ~18% to a level consistent with where it traded when the merger was first announced back in 2016.

The market remains cautious around the benefits to flow from the company-transforming merger with Tatts. There is a reluctance to give management credit for the full $130 million of synergies within the expected timeframe, nor recognise the greater balance sheet flexibility that a more diversified earnings stream provides.

There is also a considerable lack of understanding around the speed and scale of the benefits to arise from regulatory change, in particular the introduction of a Point of Consumption tax in key Australian States.

Our view

The retracement in the TAH share price to pre-merger levels implies a failure to recognise the significant improvement in the earnings outlook and provides us with an attractive entry point. More specifically, the rationale for our investment is based upon:

- Improving operating conditions that provide near term earnings certainty,
- Merger synergy upside,
- Favourable regulatory change that alters the competitive landscape,
- Sunbets rectification,
- Balance sheet capacity for an EPS accretive buyback.

An increase in the frequency of large jackpots continued through to January and should assist turnover in the lotteries business, albeit the jackpot run is likely to normalise in future periods.

Consensus earnings estimates factor in a merger synergy profile that in our view, appears too conservative. The market assumes an annual run rate of approximately $112 million will be achieved by FY20. We expect TAH will deliver the full target of $130m in FY20 - a year earlier than management have guided - and more than $140 million by FY21 because:

- The extended regulatory approval process has provided TAH with additional time to prepare integration plans so it can hit the ground running,
- The majority of the synergies will come from head count reduction and product pricing improvements that can be quickly and easily implemented,
- The synergy target does not include any material benefits from the lotteries division (>30% of group EBITDA), and
- Loss making Luxbet becomes redundant post the acquisition of Tatts - its closure will boost pre-tax earnings by circa $10-13 million per annum from FY19 and is not included in TAH's synergy target.

For over a decade, TAH's core wagering business has been under significant pressure from the successful entry of corporate bookmakers that until now, had a structural advantage operating out of the low tax jurisdiction in the Northern Territory. But regulatory change in TAH's favour should level the competitive playing field.

- A Point of Consumption (POC) tax will likely be in place nationally in coming months and TAH should be made whole by State governments, with exemptions or offsets. The tax impost on TAH's competitors will force them to change product pricing and/or restrain their marketing activities. It will deliver yield (win rate) improvements for TAH and/or make it easier for TAH to defend its previously threatened market share.
- Synthetic lotteries, like the products offered by corporate bookmaker Lottoland, are likely to be outlawed or more heavily restricted (due to tax leakage). The Northern Territory has already banned corporate bookmakers from taking bets on domestic lotteries. More far reaching changes are likely to occur when other States, as we expect, ban betting by their residents on all lotteries given international lotteries with the large jackpots make up the lion's share of turnover for synthetic lottery providers like Lottoland.
- Stricter advertising restrictions for all wagering operators will be in place by early 2018 and should make it more difficult for corporate bookmakers to win customers from TAH.

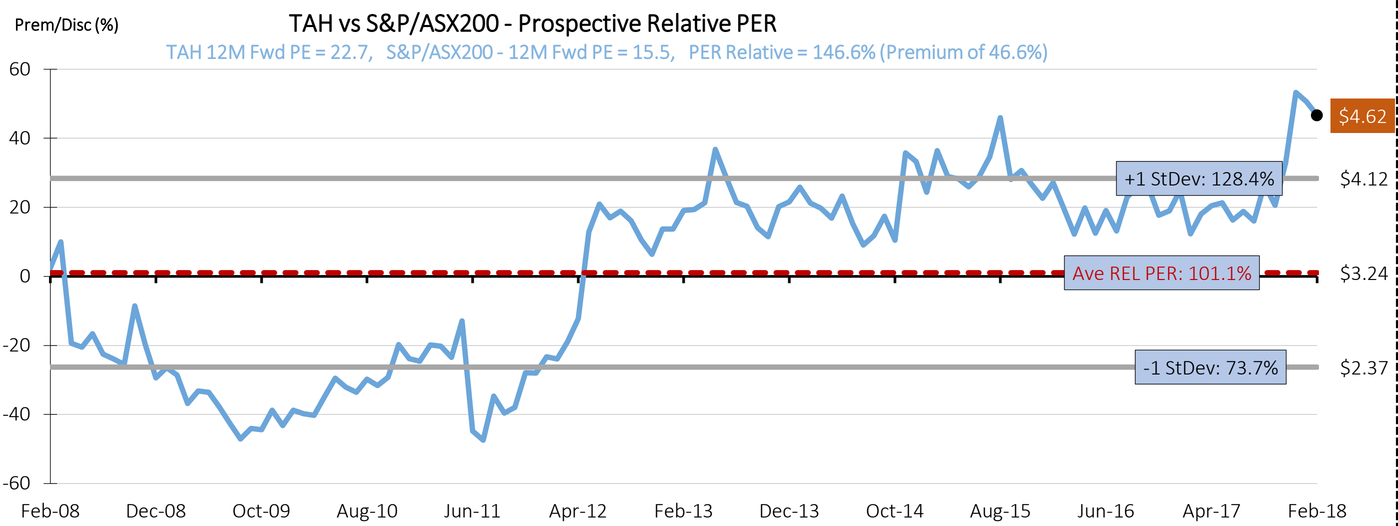
TAH's UK wagering JV, Sunbets, has been a large drag on earnings (losses of greater than $40 million pre-tax). Either TAH finds a way to improve the profitability of the business inside the next 18 months, or it will trigger an exit clause, close the business and eliminate further losses.

The merger with Tatts creates a larger more diversified earnings base for the group. Gearing initially steps up, but strong cash flow generation should provide TAH with flexibility to go ahead with a previously announced share buyback of circa $500 million, lifting EPS by another 3-4%.

Mispricing

At first glance, TAH appears to trade at the upper end of its PE bands. But in this case multiple based valuation methods based on historic ranges fail to capture the huge potential upside to consensus earnings from higher and faster than expected merger synergies, favourable regulatory change that permanently improves the competitive environment, business restructuring and a material buyback.

We can also justify a modest sustainable re-rate in the earnings multiple compared to history to reflect the inclusion of the high quality "annuities style" lotteries business into the new earnings mix.



Source: Datastream, FactSet, CLSA

Prices: 28-Feb-2018

Suncorp Group

Suncorp Group (SUN) was introduced to the portfolio midway through February, in the eye of the storm. SUN's 1H18 results missed consensus earnings expectations, with the miss largely driven by weaker earnings from its Australian General Insurance division, in particular, softer insurance margins as a result of higher catastrophe (CAT) claims towards the end of 2017.

We had been assessing SUN's value and observing its relative underperformance for some time. The sell-off in the share price on the day of its 1H18 results provided an opportunity to swoop on SUN shares at $12.93 per share cum the 33 cents a share fully franked dividend.

Investment case

At the time of reporting its 1H18 results, SUN's shares had underperformed the market by approximately 13% since its 2H17 results. While its valuation was starting to look attractive, there was some concern that the result could be negatively impacted by the phasing of its cost reduction program - called the Business Improvement Program (BIP) - and by weaker Australian general insurance margins from CAT claims.

Following the disappointing 1H18 results, margins were effectively re-set, with SUN providing guidance for 2H18 and FY19. Specifically, the company said that it expected a "stronger outlook for the second half, with favourable operating conditions expected to continue". It also expected its strategic programs to support growth and deliver cost efficiencies. Unusually, SUN provided very specific guidance for FY19. It now expects:

- Top line growth of 3% to 5%,
- An underlying insurance trading margin of at least 12% (from 10.2% in 1H18),
- The cost to income ratio in banking to be 50% and net interest margin between 1.8% and 1.9%, and
- To return the operating cost base to $2.7 billion.

That guidance is of course subject to natural hazards coming in below budget (SUN has been a notorious underachiever on this metric) and investment market movements going according to plan and no unforeseen regulatory changes.

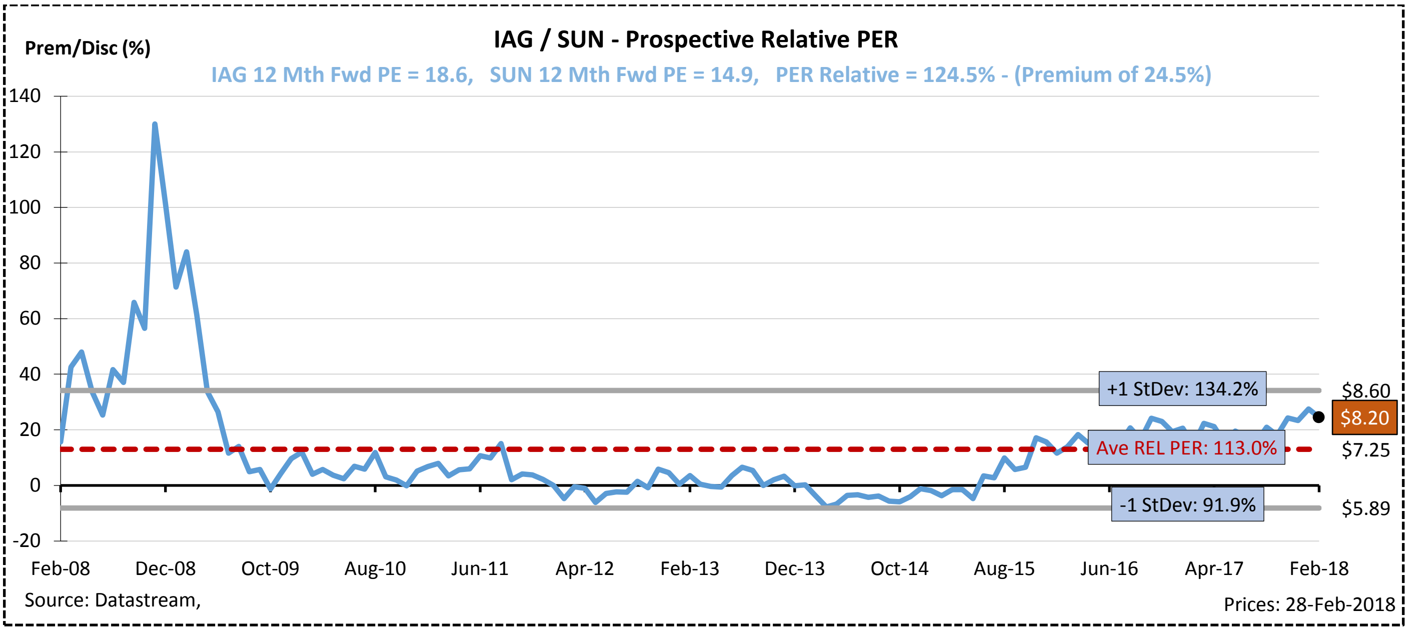
The new guidance provides a clear line in the sand, especially with respect to operating cost reductions. Also, we are encouraged by consistent evidence that home, motor and commercial insurance rates are hardening ahead of claims inflation, with stability in other classes of insurance. These two factors should provide SUN with a tailwind to deliver against its targets, leading to improved margins and higher earnings.

While some elements of the group's strategy and guidance remain unclear and carry execution and hazard protection risk, we believe there is absolute and relative valuation appeal in SUN at our $12.93 entry price. On consensus forecasts, SUN is trading on a Price to Earnings ratio of around 13.5 times and 12.7 times in FY19 and FY20 respectively. It is forecast to deliver growth in earnings per share of over 20% in FY19 and 6% in FY20 and is supported by an attractive dividend yield of almost 6%.

General insurance: The general insurance underlying margin (ITR) declined sharply in 1H18, primarily due to CAT claims, but the extent of the decline surprised the market. There is some debate on the validity of SUN's explanation of the decline in underlying ITR from 12% in 2H17 to 10.2% in 1H18. However, it could be argued that this is "in the price". The test for SUN is delivering on its target of at least 12% underlying ITR in FY19.

Looking forward, one of the key drivers of ITR will be the business improvement program (the BIP). This does carry execution risk, but the management team understands that they will be held to account. Firming rates in home and motor insurance ahead of claims inflation and the outplaying of rate increases in commercial insurance, along with reserve release should provide a tailwind to margins and help the company achieve its guidance. The general insurance division accounts for close to 60% of the valuation of SUN.

SUN trades on a discount of nearly five PE points to IAG based on their respective ratios. The most obvious reason for the discount is the performance of underlying ITR. In 1H18, IAG's ITR expanded, while disappointingly, SUN's declined. Other reasons for the discount include IAG's quota share arrangement (that reduces margin and hence earnings volatility) and the difference in composition of SUN's business mix (comprising general insurance, life insurance and banking). The wide 4 PE point gap could be narrowed if SUN management delivers against its forecasts.



Bank: SUN's bank has solid momentum in terms of loan book growth and overall profitability. While the impairment charge was low and below the long-term guidance, the bank appears to have maintained disciplined credit selection and has a diversified book.

Looking forward to FY19, the cost to income ratio is expected to trend back to the long-term target of around 50% and net interest margin is targeted to be in the range of 1.8% to 1.9%. Even with the impairment charge normalised to 10 basis points in FY19, the bank's earnings are expected to be solid, contributing just over 30% of the group's cash earnings.

Australian Life business: SUN has announced a strategic review of this business which is ongoing. An update is expected in 2H18. Depending on the outcome of the review, the market expects that excess capital could be released to shareholders. The embedded value (EV) of the life business (including franking credits) is currently around $2 billion. Recent life insurance transactions have been in the range of 0.9 times to 1.1 times EV and provide a sense of what SUN could realise from its strategic review if the entire life business is sold.

Business Improvement Program: The BIP is contentious but is at the core of SUN achieving its operating expenses target of $2.7 billion and improving margins. The BIP focuses on five streams of work: digitisation of the customer experience, sale and service channel optimisation, end-to-end process improvement, claims supply chain re-design, and smarter procurement and streamlining of the business. Critics argue that the BIP carries execution risk. While we agree that it does and that some of the benefits will be hard to track, reducing or optimising costs to increase value should be the core focus of all management teams. SUN's management team should be able to control this aspect of their business.

Conclusion

Our analysis leads us to believe that $12.93 per share (cum a 33 cents a share fully franked dividend) is a very attractive entry point to SUN. While there remains some execution risk with its strategy, there are positive tailwinds from firming rates and a cost-out program that should drive double-digit earnings growth on average over FY19 and FY20. This gives us comfort that that there is valuation upside on both an absolute and relative basis. The strategic review of the group also suggests that each of the group's divisions offer value in their own right.

BHP Billiton (BHP) and Rio Tinto (RIO)

Following on from last month's sales, we totally exited the Fund's position in BHP prior to the release of its disappointing full year result. The main area of disappointment was its dividend, higher than expected closing debt levels and cost inflation across all its business units.

We also continued to take further profits and reduce the holding in RIO, as the stock has been re-rated significantly following stronger commodity prices and commensurate earnings upgrades, which now seem priced in. The stock has become a consensus long and now trades above its longer-term DCF valuation.

When we first started buying RIO at $43.70 back in March 2016 for the Fund, it was the bottom of the cycle and you could not give RIO shares away for love or money. Late last month, we sold stock at $80.89. Fair to say, it’s been a fruitful investment! The fund is now underweight RIO.

As per previously articulated reasons, we have continued to selectively add to core positions, namely: **JB Hi-Fi, DuluxGroup, Graincorp, Fletcher Building** and **Nufarm**.

Similarly, as we have previously outlined, on valuation grounds and our assessment that capital could be deployed more effectively elsewhere, we reduced our positions in **Link Administration, Primary Health Care** and **Star Entertainment Group** (complete exit).

AWE Limited (AWE)

We decided to divest just under half of the portfolio’s AWE holding at levels above the $0.95 a share recommended offer price to fund purchases of other opportunities which we currently believe offer a better risk/reward equation and to strengthen existing holdings.

Mitsui implementation bid underway

As it currently stands, the AWE Board has recommended that shareholders accept the Mitsui bid in the absence of a superior offer (all cash $0.95 a share). The bid represents a healthy 74.3% premium to AWE’s closing price of $0.545 a share on 29 Nov 2017, the day prior to the disclosure that China Energy Reserve and Chemical Group Australia had approached AWE and then lopped a 70 cent cash bid on the table. AWE’s target statement has concluded that the Mitsui offer was “fair and reasonable” and independent experts Grant Thorton valued the shares at 78 cents to $1.06. The Mitsui bid is subject to a 50.1% minimum acceptance condition and a limited number of other conditions, however, it is not subject to any regulatory approvals or financing conditions. The offer period closes 23 Mar 2018.

Waitsia Stage 2 - Mitsui bid terms prohibit additional gas marketing

Given increased M&A activity across both JV partners, the Waitsia JV is currently assessing design tenders submitted in November last year. Project timing remains unchanged, with first gas expected in 2020, but this is dependent on the delivery of FID in 2H 2018. While Waitsia Stage 2 requires additional gas sales agreements of circa +50TJ/d to underwrite the project, the current terms of Mitsui’s bid prohibits AWE from signing additional gas sales agreements.

Fletcher Building (FBU)

We thought we should provide an update on **Fletcher Building** given we have added to this recently established position.

On 14th Feb, FBU announced further provisions for expected losses in its Buildings + Interiors (B+I) division of NZ$467 million, culminating in total expected B+I FY18 projected losses of $592m and a EBIT loss of NZ$660 million. This compares to previous guidance of -NZ$160 million at EBIT line.

These provisions are the result of reviews under new CEO Ross Taylor (who only became CEO in November 2017), including a full review of 16 B+I projects accounting for over 90% of the construction backlog. The provisions factor in cost and timeline contingencies beyond the target completion dates.

As a result of the increased provisions, the company now has:

- Better visibility and certainty of cost forecasts,
- Advanced significantly further on procurement of important trade packages significantly, and
- Incorporated material price increases across trade finishing costs.

The increase in the non-cash B+I forecast loss has resulted in a breach of FBU's financial covenants to its commercial banking syndicate and USPP noteholders. If the non-cash portion of the losses are excluded, the company would have remained within its covenants. The company has received a waiver from the banking syndicate and commenced discussions with the USPP noteholders. The company is targeting for all negotiations to complete by the end of March. FBU has also stated that no dividend will be declared for 1H18.

Importantly, in response to the issues in B+I, Ross Taylor has announced that FBU will not be bidding on any further construction work in NZ, allowing for teams to focus solely on project completion. This problematic business segment is effectively now in run off.

Chairman Sir Ralph Norris has announced his decision to step down no later than the 2018 Annual Shareholder's Meeting, which we regard as a positive given these issues happened under his watch.

We are very encouraged that despite the issues in B&I, the company confirmed previous guidance for EBIT (excluding B+I) to be robust and in the range of NZ$680-720 million. Importantly, there should be very little spill-over impacts from the B+I issues to the remainder of the group. The problems are clearly contained within that business unit.

While the expected B+I accounting loss of NZ$660 million in FY18 is large, it should be noted that the cash flow impacts are less drastic as they will be incurred over the remaining life of the projects ie FY18-FY20.

Cash flows for the remainder of the business are strong and in fact management has guided to an improvement in cash flow excluding B+I of ~$700 million vs $635 million in FY17.

In our December 2017 monthly newsletter we outlined the reasons for our contrarian view of the stock:

- While there could be further losses in the Construction division, these are finite and will cease once the projects complete, likely in 2019.
- As part of his strategic review, the new CEO could look to divest certain assets.
- Asset sales would reduce pressure on the balance sheet.
- While the New Zealand housing cycle is at or near the top, there is a reasonable chance it stays at elevated levels given the pipeline of work.
- Australian building materials companies have rallied strongly over the past 12 months with earnings multiples expanding while FBU has seen the opposite effect.

While the announcement of further B+I provisions are disappointing and caught us (and the market) by surprise, we believe our investment thesis remains intact and that the stock will re-rate over time as these issues are remedied.

We have subsequently added to the position late in the month (down to A$6.00), a level that we believe, will prove to be attractive for investors with a longer term time horizon.

Strategy & Outlook

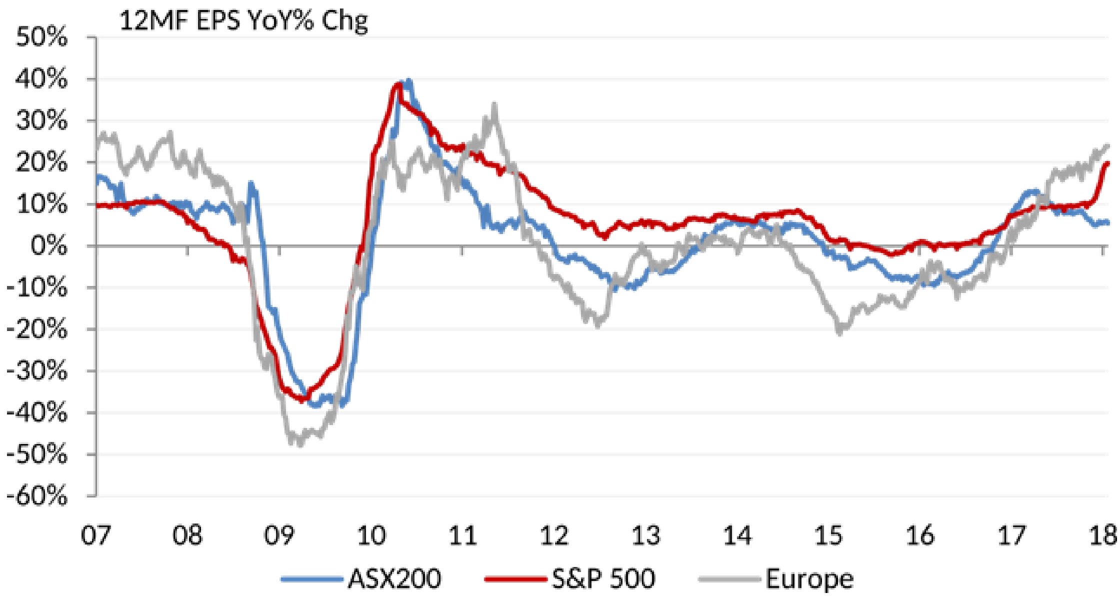
Some Solid Results Domestically, but Still Lagging the Global Earnings Upswing

With reporting season now complete, beats exceeded misses 2 to 1 and FY18 estimates have been edged up about 1% on average. While marginally better than "normal", Australian earnings continue to lag the global uptrend, both in terms of the rate of earnings growth and the rate of earnings revisions (which are very positive globally).

The Australian equity market has recovered most of its early month sell off triggered by US inflation jitters and currently sits on 15.2x 1-year forward expected earnings (with the resources sector still notionally cum large upgrades based on current spot commodity prices).

Consensus estimate for FY18 eps growth now stands at 6.6% and 4.3% ex Resources. Growth for the Industrials ex Financials is only 4.7% against a demanding 18.5x forward PE. **Australia's aggregate growth rate is pedestrian in a global context and while the reporting season has confirmed pockets of growth, valuations in these higher growth areas seem stretched.**

US earnings estimates have risen sharply since the US tax reform bill was passed while forward multiples peaked in December, now trading at 17.1x (from a peak of 18.5x). Whilst ASX 200 earnings are flat year-on-year, trading on a PE multiple of 15.8x.



Source: RIMES, IRESS, Morgan Stanley Research.

We indicated in January that we expected volatility, as measured by the VIX (which has been trading at historically low levels for a long period), to rise sharply. Well volatility certainly returned in February!

The only other key development or elevated risk from last month's strategy and outlook is the real prospect of a trade war following President Donald Trump's statement that the US will slap tariffs on steel and aluminum imports under S201. This "beggar-thy-neighbor" policy, which was very popular in protecting domestic industries during the Great Depression, needs to be monitored very closely.

"We'll be imposing tariffs on steel imports and on aluminum imports. We will be signing it in and you're going to have protection for the first time in a long time," Trump told metals industry executives at high level meetings at the White House. Trump is favoring tariffs of 25 percent on steel and 10 percent on aluminum, both of which would exceed the most severe option presented to him by the Commerce Department.

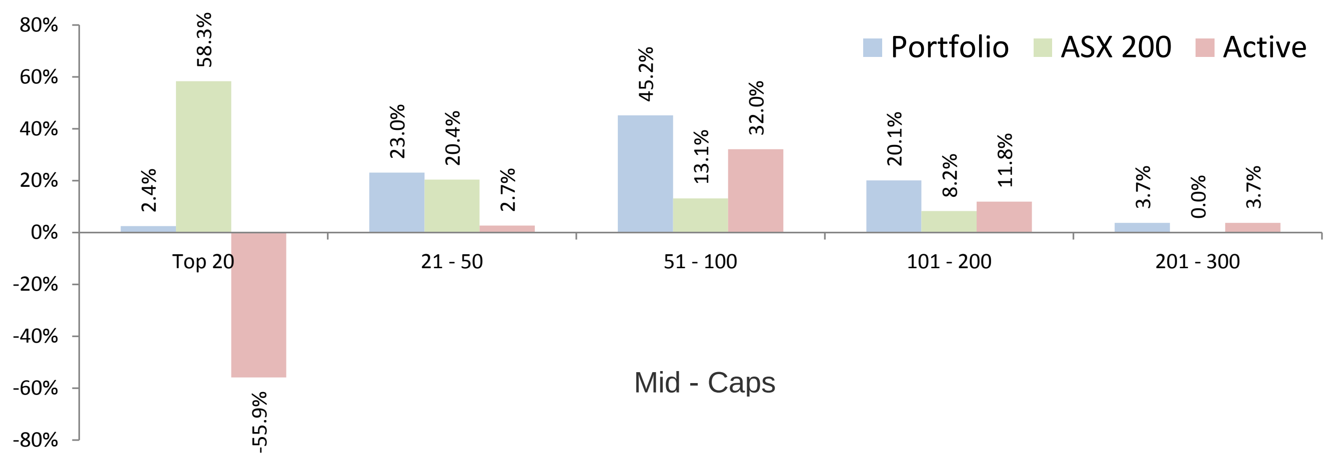
A US move on tariffs may provoke retaliation from China, the world's biggest steel and aluminum producer. China has already launched a probe into US imports of sorghum and is studying whether to restrict shipments of US soybeans. These targets could hurt Trump's support in many farming states. The Europeans have also indicated that they would retaliate.

Such actions will no doubt lead to increased volatility and trouble markets, so stay tuned.

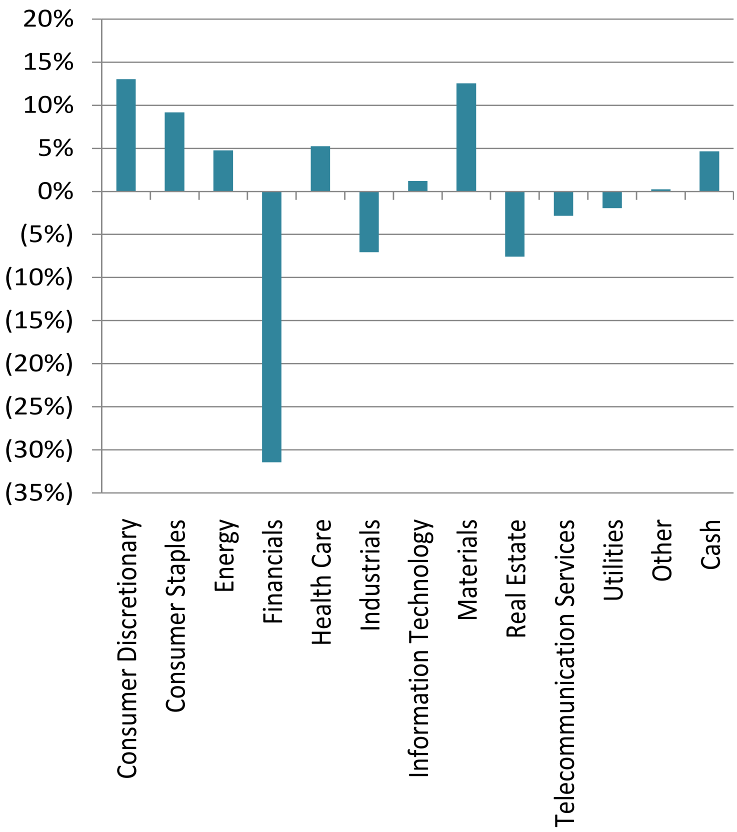
Warm Regards,

Chris Kourtis
Portfolio Manager

SIZE Comparison Chart vs ASX 200



Active Sector Exposures*



* Active sector exposures are determined by subtracting fund sector weights from benchmark weights. Positive percentages represent over-weight sector exposures relative to benchmark and negative percentages represent under-weight sector exposures relative to the benchmark.

Core Holdings

BLUESCOPE STEEL
GRAINCORP
HEALTHSCOPE
JB HI-FI
NUFARM
ORICA
ORIGIN ENERGY
PRIMARY HEALTH CARE
TABCORP HOLDINGS
TREASURY WINE ESTATES

Asset Class Exposures

Exposure (% NAV)	Net
Equity	95.1%
Long Option	0.0%
Short Option	(9.2%)
Effective Cash	14.1%
Grand Total	100.0%

About the Ellerston Overlay Australian Share Fund

The Fund aims to achieve its performance objectives by adopting a fundamental "bottom-up" investment approach to stock selection whilst delivering additional income where possible, through option strategies.

Because of the nature of the strategy, at least 75% of the Fund's exposure is aligned to the portfolio of the Ellerston Australian Share Fund.

The Investment opportunities for the Fund are identified by analysing and understanding the factors affecting (amongst other things): business model, industry structure, management team and overall valuation.

Ellerston Capital typically favours businesses that can sustain high returns or improve their return on capital and looks to invest in businesses with a market value below the value we attribute to them.

Benchmark weightings do not drive our stock decisions; our approach is totally benchmark independent.

Strategy Funds Under Management	$231 Million
Funds Under Management - Overlay ASF	$26 Million
Application Price	$1.2107
Redemption Price	$1.2047
Number of Stocks	19
Inception Date	4 January 2012

Note: Unit prices reflect Class A only.