ELLERSTON CAPITAL

# Ellerston Australian Market Neutral Fund

PERFORMANCE REPORT June 2018

## Fund performance^ (Net)

| Net | Jan | Feb | Mar | April | May | June | July | Aug | Sept | Oct | Nov | Dec | YTD |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| 2018 | -0.03% | 0.54% | -0.34% | -1.19% | -0.28% | 1.05% | | | | | | | -0.26% |
| 2017 | 0.54% | -0.98% | 0.47% | -0.01% | -0.57% | 1.64% | -0.40% | 0.87% | 0.12% | 1.09% | -0.20% | 2.14% | 4.76% |
| 2016 | -0.97% | -1.03% | 0.80% | 0.10% | 1.34% | 0.55% | 0.71% | 1.93% | 0.73% | -0.53% | 0.29% | 0.02% | 3.96% |
| 2015 | -0.15% | 1.09% | 1.41% | 1.04% | -0.11% | 1.29% | 0.71% | 1.11% | 0.88% | 0.59% | 1.37% | 1.09% | 10.81% |
| 2014 | 2.50% | 0.33% | 0.93% | -0.47% | 2.31% | 3.60% | 1.24% | 2.42% | 3.16% | -0.82% | 1.53% | -0.95% | 16.82% |
| 2013 | | | | | | 0.48% | 1.12% | 1.74% | 1.38% | 2.87% | -0.34% | 2.54% | 10.18% |

^ The net return figure is calculated after fees & expenses. The gross return is calculated before fees & expenses. Past performance is not a reliable indication of future performance. The benchmark is the RBA Cash Rate. The Fund commenced on 3 June 2013.

| Return | Net | BM | Alpha | Gross | Portfolio Metrics | |
|---|---|---|---|---|---|---|
| 1 Month | 1.05% | 0.13% | 0.91% | 1.36% | Positive months | 72% |
| 3 Months | -0.44% | 0.38% | -0.82% | -0.35% | No. Relative Value positions | 126 |
| 6 Months | -0.26% | 0.75% | -1.01% | -0.03% | No. Special Situations | 37 |
| 1 Year | 3.37% | 1.50% | 1.87% | 5.02% | Net Equity Exposure | +24.9% |
| 2 Years p.a | 3.83% | 1.50% | 2.33% | 5.68% | Gross Portfolio Exposure | 152.2% |
| 3 Years p.a | 4.78% | 1.66% | 3.12% | 6.92% | Beta Adjusted | 4.5% |
| Since inception p.a | 8.99% | 1.98% | 7.01% | 12.14% | Correlation Coefficient (vs ASX 200 Accum) | -8.64% |
| | | | | | Net Sharpe Ratio ( RFR = RBA Cash) | 1.86 |

## Performance

A better performance for the Fund in June, producing a net return of 1.1% compared with the benchmark return of +0.1%. An uptick in volatility helped Relative Value, with the strategy returning 1.4% (gross) in the month. The contribution from Special Situations was flat in the period.

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The Fund closed the month with net exposure at +24.9% and a beta-adjusted net of +4.5%. Gross exposure continued to reduce, closing the month at 152.2%.

Our expectation of industry consolidation in the Manufactured Housing Estate (MHE) sector came to fruition during June, with three takeover bids lodged for Gateway Lifestyle (+32.4%), on the heels of their earnings downgrade in May. We were well positioned for the bids, with paired positions featuring a long in Gateway amongst the biggest contributors in the period. With the company well and truly “in play”, we unwound the pairs and moved the residual Gateway holding to Special Situations.

Given the interest in Gateway, it was little surprise to see the price of other MHE companies also rally with Ingenia Communities closing +14.9% higher in the month. During the period, the company upgraded FY18 EPS guidance by 10% and confirmed that 40% of forecast FY19 settlements were already contracted. Non-core asset sales were also reported, with $60m of the $100m in non-core assets now contracted for sale. The share price clearly has momentum, with the market speculating that the under bidder on Gateway will turn its attention to Ingenia at some point. Paired positions that featured a long in Ingenia added value to the Fund.

Our paired position between rural services’ companies Ruralco Holdings (+0.0%) and Elders (-4.4%) also added to the performance of the Fund. During the month, Elders held a strategy day where it became apparent the company is evaluating a material acquisition, which if successful, would require an equity raise. The market is speculating that one of the options is NZ-based PGG Wrightson (-5.7%), a move that would be at least 10% accretive to earnings, but would require an equity raise of $500m. Despite the underperformance of Elders, we continue to maintain the pair - Ruralco still trades at a material discount to Elders, with an FY18 EV/EBITDA multiple of 6.5x compared with Elders at 14.0x.

Paired positions that featured a short in National Storage REIT (+6.9%) detracted from the value of the Fund, with the self-storage owner and operator continuing to outperform its property peers. During the period, the REIT confirmed a half-year distribution that was at the bottom of guidance, indicating earnings were likely to land at the lower end of expectations. Historically, National Storage has struggled to simultaneously grow both occupancy and Revenue Per Available Square Meter (RevPAM) and we look forward to next month’s results announcement to assess management’s progress on these metrics.

Crude oil futures staged a late rally during June, with the commodity closing the period at US$74.15 per barrel, +10.6% higher than at the end of May. The move in oil was reflected in the share prices of both Sundance Energy (+10.1%) and Elk Petroleum (+6.8%), with both positions adding value during the period.

Increased interest in telco infrastructure company Superloop (+7.2%) also aided performance, with the stock continuing to rally from its April low. The stock continued to benefit from its maiden Investor Strategy day, held in May.

A fall in the price of 2020 Large-Scale Generation Certificate (LGC) futures looks to have caused some concern around the future earnings for renewable energy companies, including Infigen Energy (-11.4%). Accredited renewable energy power stations are entitled to create LGCs, which can be sold to liable electricity retailers who are required to surrender a set number to the Clean Energy Regulator each year. Given the recent corporate activity in Tilt Renewables (-0.5%) and the raid on the Infigen register by Brookfield in April, we remain confident that the company will be involved in industry consolidation at some point.

During the month, Capitol Health (+10.2%) reconfirmed FY18 earnings guidance and announced the acquisition of nine individual clinics, with 6 located in Western Australia and 3 in Victoria. The acquisitions are expected to add $3.1m in EBITDA on a full year basis, and are scheduled to close in Q1 FY19. The clinics acquired represent their first entry into WA with further bolt-on acquisitions expected. The market appreciated the continuation of Capitol’s diversification strategy and marked the share price up accordingly.

The share price of Impedimed (-25.5%) retreated during the month, with our long position detracting from the performance of the Fund. There was no new news on the company in the period.

## Activity

### Relative Value – Gross Contribution 1.39%

We unwound both pairs that featured a long in Gateway, following the initial takeover bid from Hometown America. We also reduced our exposure to Ingenia by a third, closing down two of our pairs and reducing the size of others. Whist we remain confident of the sector, we are mindful of increasing domestic housing headwinds, which may impact future growth.

Following a narrowing of the spread, our paired position between infrastructure stocks Transurban (+3.2%) and Sydney Airport (+0.8%) was unwound. We also established, and promptly unwound a paired position between Meridian Energy (+4.5%) and Contact Energy (+1.6%) during June, capitalising on a mid-month index rebalance in New Zealand.

The IPO of Viva Energy Australia was launched in June, with the company expected to list in July. Viva Energy Australia is the sole tenant of Viva Energy REIT (+9.8%) and operates almost 1,200 service stations and 44 fuel import terminals nationwide. The disclosure around the IPO illustrated the strength of the Viva Energy business and provided some comfort around the long-term viability of the REIT's tenant. In addition, the recent announcement by Wesfarmers (+8.3%) that they would be demerging Coles provided additional comfort in the relationship between Coles and Viva Energy, given the importance of Coles Express to the Coles business. The REIT trade higher in the period and we were able to unwind two pairs in which it was featured as a long, hedged with GPT Group (+3.1%) and Goodman (+4.5%).

Our buy/write position in Fairfax Media (+5.6%) expired at the end of June, with our long holding delivered against the exercised calls and the position removed from the portfolio.

### Special Situations – Gross Contribution -0.03%

A modest position was established in the newly issued CVC hybrids (0.0%), a traditional convertible note. CVC (+2.3%) invests in unlisted companies offering medium and long term returns, with a focus on established companies with positive cash flows. The hybrid pays an unfranked, floating coupon of 3.75% above the 90 day bank bill rate, currently approximately 5.86% pa. The note has embedded call options with a strike price of $3.40, about 28% above the current share price of CVC.

We participated in an equity raise for Pro-Pac Packaging (-6.3%) during the period, adding to our existing holding. Proceeds of the raise will be used to fund the acquisition of two companies – Perfection Packaging and Polypak, with the deals expected to be 22% accretive to EPS within 2-3 years. Perfection Packaging is a Victorian-based hard flexible manufacturer, while Polypak is a NZ based soft-flexible manufacturer and distributor. The acquisitions and forecast accretion serves to illustrate the consolidation opportunities that exist in flexible packaging for Pro-Pac. The company also provided an update to the sales process of their non-core rigid packaging business, which is entering the final stages of divestment.

A long position was established in PGG Wrightson (-5.7%), a New Zealand agriculture supply business with assets in New Zealand, Australia and Uruguay. PGG are specialized in pastoral seeds with high market share in both Australia and New Zealand. PGG has had a trying time over the last seven years, however under new management, we have seen a turnaround in both margins and profitability driving higher returns to shareholders. The Board of PGG is currently conducting a strategic review with the outcome anticipated for later this year. As mentioned above, press speculation in recent months has suggested that one outcome from the strategic review is a sale of the entire business, with Elders (-4.4%) the logical buyer.

During the month, we participated in a sell down in Aurelia Metals (-5.0%), an Australian gold and base metal explorer and developer. Long-term shareholder, Pacific Road Capital sold their entire 36.7% stake to fund additional investments within the mining sector. The stock traded well following the sell down and we were able to unwind the shareholding by the end of the month, netting more than 10% on the position.

## Sector Allocation

| Sector | Long Equity | Short Equity | Net Equity |
|---|---|---|---|
| Banks | 0.6% | 0.0% | 0.6% |
| Div Financials | 1.4% | -1.1% | 0.3% |
| Insurance | 0.7% | 0.0% | 0.7% |
| Regional Banks | 0.0% | 0.0% | 0.0% |
| REITs | 48.4% | -45.5% | 3.0% |
| Financials | 51.1% | -46.6% | 4.6% |
| Builders | 2.5% | -2.6% | 0.0% |
| Consumer Disc | 4.7% | 0.0% | 4.7% |
| Consumer Staples | 1.1% | -0.7% | 0.4% |
| Contractors | 1.2% | 0.0% | 1.2% |
| Gaming | 0.0% | 0.0% | 0.0% |
| General Industrials | 1.9% | 0.0% | 1.9% |
| Health Care | 5.1% | 0.0% | 5.1% |
| Information Technology | 1.6% | 0.0% | 1.6% |
| Infrastructure | 0.0% | 0.0% | 0.0% |
| Materials | 0.0% | 0.0% | 0.0% |
| Media | 4.1% | -2.2% | 1.8% |
| Telcos | 0.0% | 0.0% | 0.0% |
| Utilities | 3.8% | 0.0% | 3.8% |
| Industrials | 25.9% | -5.6% | 20.3% |
| Bulk Metals | 6.6% | -6.5% | 0.1% |
| Energy | 2.7% | 0.0% | 2.7% |
| Gold | 0.0% | 0.0% | 0.0% |
| Resources | 9.3% | -6.5% | 2.8% |
| Hedge | 0.0% | -2.9% | -2.9% |
| Index | 0.0% | -2.9% | -2.9% |
| **Total** | 86.4% | -61.5% | 24.9% |

# Market Commentary

## Market Overview

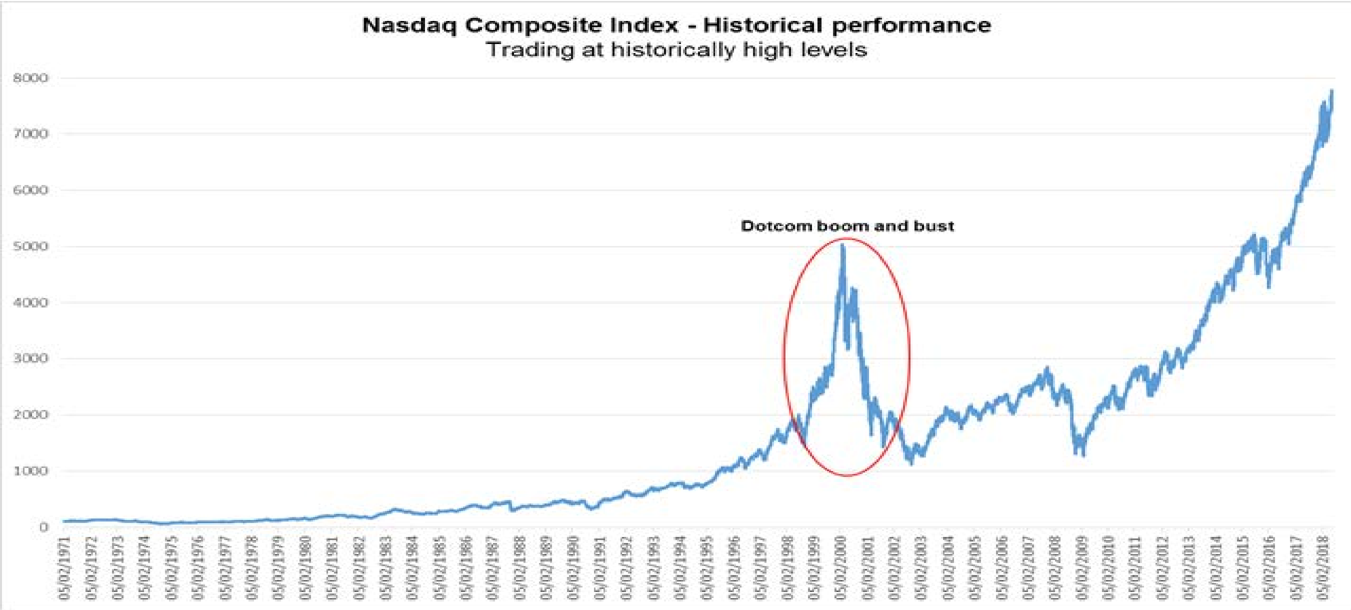
June was a torrid month for global equities, but the Australian share market bucked the trend and was the star performer, outperforming the major US, European and Asian equity markets. Overall, developed markets significantly outperformed emerging markets (for the third consecutive month), with emerging markets' weakness driven by a further sell-off in the Chinese market, a stronger US dollar and heightened fears of a damaging trade war. As widely expected, the Fed raised interest rates by another 25 basis points in June (the second time this year), given its view on US inflation and a robust labour market, coupled with solid economic growth. The US labour market has staged one of history's most astonishing recoveries over the past decade, a turnaround that has surprised all observers. The unemployment rate has dropped from a peak of 10% in October 2009 (the second highest in the post-war period), to just 3.8% in May 2018 (the lowest seen since 1969). This remarkable fall is the largest experienced during a single cycle in the modern era. That said, wages growth remains below its pre-GFC average, prompting much commentary.

Trade tensions did not abate during June, with the US and China failing to reach a resolution. US, Canadian and European officials also continued to ratchet up their rhetoric on tit-for-tat tariffs. Markets weren't given much direction from the G7 summit either, ending with the leaders squabbling over the contents of their final communique, and President Trump refusing to sign the final release. The much anticipated meeting between President Trump and North Korea's Kim Jong-Un finally took place and resulted in a vague statement on nuclear disarmament. Australia saw the RBA leave rates on hold and the Royal Commission continued its investigative work, but financials, especially the major banks, staged a relief rally from oversold levels, bouncing off their mid-June lows.

## USA

The S&P 500 Index and the Dow Jones Industrial Average Index ended June up 0.6% and down 0.5% respectively, with the NASDAQ continuing its stellar run, up 1.0% after having delivered an impressive +5.5% the previous month. The ill-tempered rhetoric on trade continued with seemingly no resolution with the DJIA trading down 5.3% intra-month. The EU also promised to impose retaliatory measures on $300 billion of US goods in response to Mr Trump's threat to impose punitive tariffs on the importation of European cars and parts, having already stoked tensions over steel and aluminium imports.

The Fed meanwhile hiked rates by another 25 basis points, with policy makers making it clear that market volatility would not divert them from their previously flagged intentions. The US 10-year bond yields closed at 2.86%, broadly unchanged versus their level from the previous month. With the yield curve flattening (the spread between the 2-year and 10-year treasuries compressing), debate rages on what this is actually telling investors. Opinion is divided, with one view holding that the long-end of the yield curve might be suggesting a looming recession. What is clear, is that the NASDAQ and technology-led stocks have had an epic run. See below, the long-term performance of the NASDAQ.




Source: Ellerston Capital Limited, Bloomberg

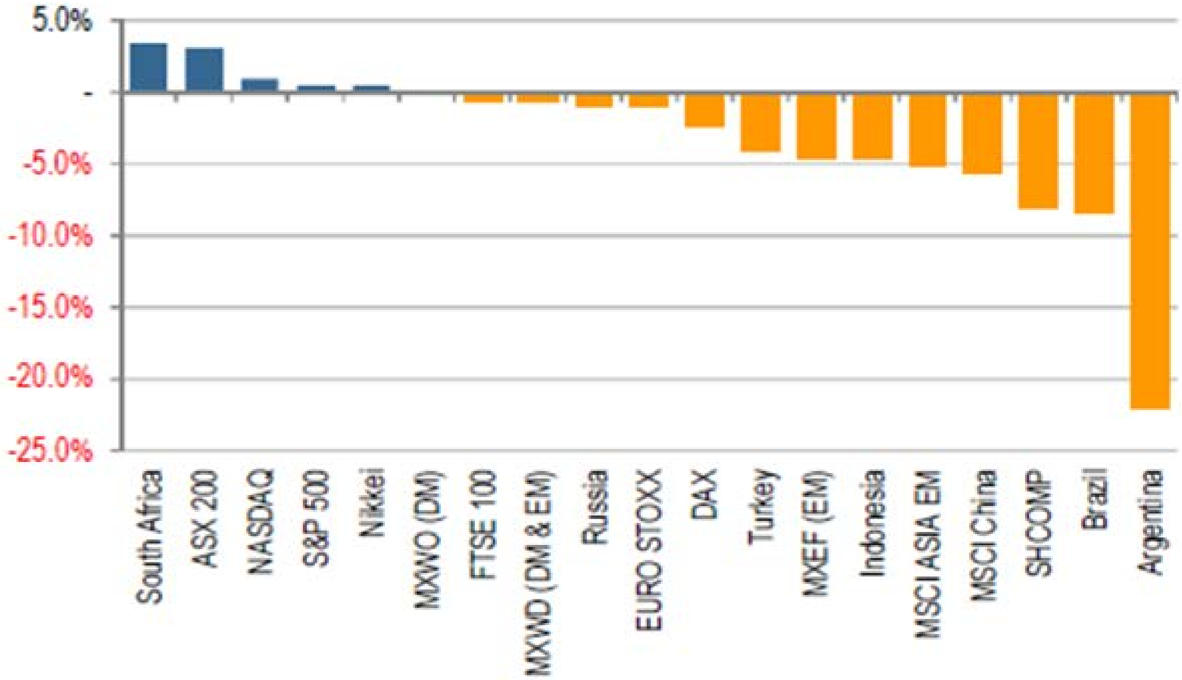
## Europe

European stocks were again weaker in June, with the Euro STOXX 50 Index declining 0.2%. France's CAC 40 returned -1.1% while Germany's DAX was down 2.4%, impacted by Trump's call for tariffs on German cars and parts and compounded by political uncertainty in Germany. The UK's FTSE 100 Index was also modestly in negative territory, down 0.2% and continued to be dogged by the lack of real progress on a post-Brexit deal. The ECB confirmed its tapering of quantitative easing, with QE expected to be completed by this December.

## Asia

As witnessed last month, fears of an all-out trade war had a dampening effect on Asian equities, with Korean and Chinese stocks hit particularly hard. As these markets have a relatively high concentration of technology stocks, the threats of tariffs battered their tech-heavy indices. The Shanghai Stock Exchange Composite Index was down almost 7%, the Hang Seng Index was down 4.5% and Korean equities were down 4.0%. Markets were also hit by a strengthening US dollar. Japan's Nikkei 225 Index had a volatile month: it initially sold off after the Trump-Kim summit, before closing the month in positive territory, up 0.6%. The Peoples Bank of China cut its reserve requirement ratio, currently at 16% for big banks by 50 basis points, injecting liquidity into its system in order to cushion the negative impact of a likely trade war. It was the third cut this year.

**Global Markets' Performance in June 2018**




Source: JP Morgan, Bloomberg.

## Commodities

Bulk commodity prices, including iron ore, thermal coal and hard coking coal all continued to firm. Oil was the stand out feature in commodity markets, with WTI crude prices rising 10.6% to US$74.15/bbl , despite the higher dollar, on concerns about tightening global oil supply. Crude prices were helped by OPEC's vague statements post the Vienna meeting where it left its overall quota unchanged, but alluded to production increases from those members with spare capacity. Gold prices dropped 3.5% to US$1,253/oz in June and despite fears of a pending trade war, there hasn't been the flight to the obvious safe haven store of value.

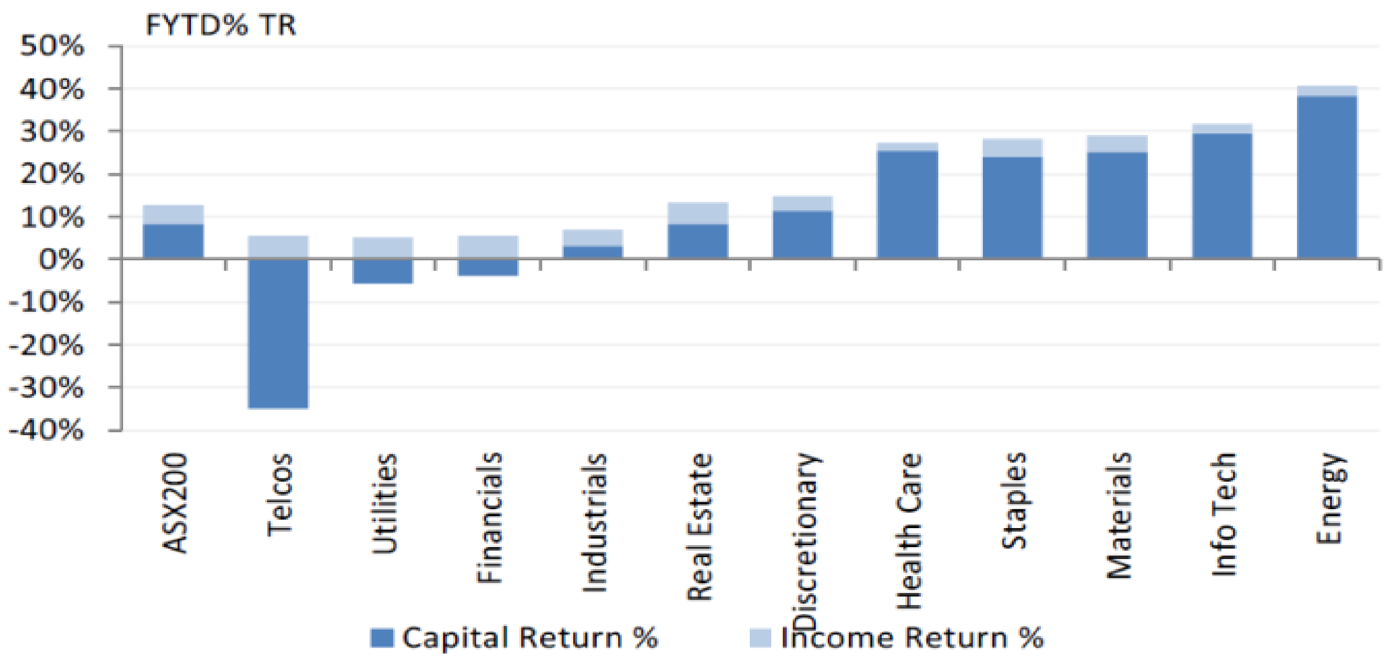
## Bonds

The US yield curve continued to flatten as the spread between the short-term rates and long-term rates narrowed. The US 10-year bond yield rose 15 basis points to close the month at 2.86%. In Australia too, the spread narrowed slightly.

## Australia

On the surface, a solid financial year for the Australian share market has actually masked a tale of two halves, with a decidedly more difficult environment for investors emerging in the past six months due to upward pressure on US interest rates, trade tensions and a loss of economic momentum outside the US.

**Total returns for the Financial Year ended 30 June 2018**




Source: RIMES, Factset, Morgan Stanley Research

The Australian equity market produced strong returns in the month of June, with the S&P/ASX 200 Accumulation Index closing up 3.3%. Both the ASX 200 Resources and Industrial Accumulation Indices returned +3.3% in the period. The Small Ordinaries Accumulation Index lagged the broader market and delivered a more modest return of +1.1%. Blue Sky Alternative ( BLA, -34.4%) was the worst performing small cap stock over the month, and continued its horror run after it released news that it was facing losses for FY18 of $59.4m, a sum greater than all of its previously reported profits since listing in 2012.

In June, most sectors were in the black, with the Energy sector (+7.8%) taking line honours, led by the likes of Woodside Petroleum (+9.4%) as oil and LNG prices continued to firm. Information Technology (+6.3%, driven by the likes of Iress +16.3%, Link Administration +6.9% and Wisetech Global +6.5%) was the next best, followed by Consumer Staples (+6.2%), led by heavyweight Wesfarmers (+8.3%). The Financials sector (+4.1%) was driven by a relief rally in the 4 major banks, but also strong performances from asset manager and investment bank Macquarie Group (+8.2%, following upgrades from sell side analysts), Clydesdale (+10.2%) and Suncorp Group (+8.6%). The telecommunication sector (-5.8%) was the worst performer, pulled down by Telstra (-6.4%) after the company's investor day fell short of market expectations and Telstra stunned the market by again rebasing its earnings downwards on a sharper than expected degradation in mobile margins.

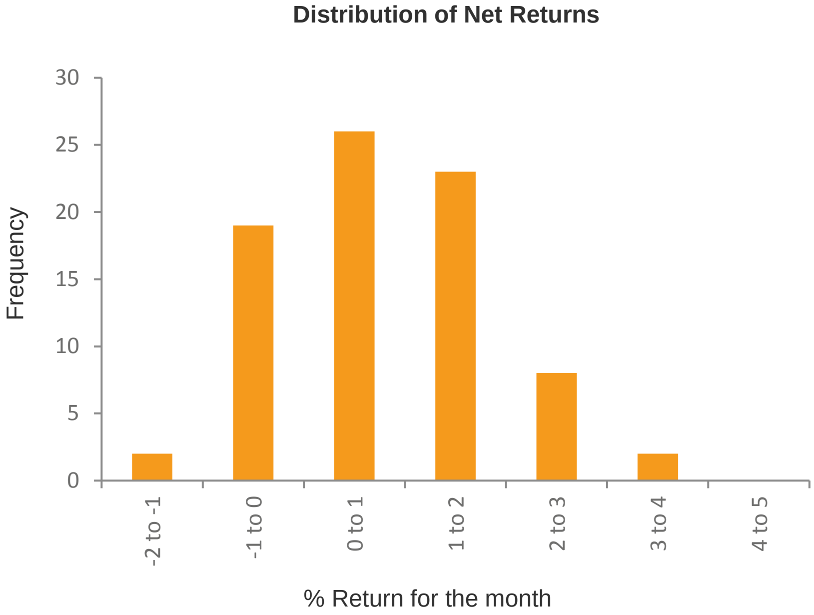
The top five stocks that contributed to the index's return were Commonwealth Bank of Australia (+38 points), Westpac Banking Corporation (+30 points), Wesfarmers (+27 points), BHP Billiton (+22 points) and CSL (+19 points).

The bottom five stocks that detracted from the index's overall return were Telstra Corporation (-13 points), AMP (-6 points), Ramsay Health Care (-6 points), Challenger (-4 points) and South32 (-3 points).

The Reserve Bank of Australia (RBA) chose to keep rates on hold again at 1.5% in June and its forward guidance was unchanged. Real GDP grew 1.0% over the March quarter and 3.1% year-on-year. The Australian dollar fell 2.2% against the US dollar.

## Contribution

| Relative Value Gross Contribution | 1.39% | Special Situations  Gross Contribution | -0.03% |
|---|---|---|---|
| **Positive** | | **Positive** | |
| ABACUS PROPERTY GROUP - INGENIA COMMUNITIES GROUP | 0.28% | GATEWAY LIFESTYLE | 0.32% |
| GROWTHPOINT PROPERTIES - GATEWAY LIFESTYLE | 0.28% | SUNDANCE ENERGY AUSTRALIA LT | 0.22% |
| CHARTER HALL RETAIL REIT - INGENIA COMMUNITIES GROUP | 0.26% | AURELIA METALS LTD | 0.18% |
| GOODMAN GROUP - GATEWAY LIFESTYLE | 0.23% | SUPERLOOP LIMITED | 0.13% |
| GOODMAN GROUP - INGENIA COMMUNITIES GROUP | 0.19% | CAPITOL HEALTH LTD | 0.07% |
| **Negative** | | **Negative** | |
| AVEO GROUP - GOODMAN GROUP | -0.18% | INFIGEN ENERGY | -0.45% |
| CROMWELL PROPERTY GROUP - PEET | -0.08% | IMPEDIMED LTD | -0.40% |
| BWP TRUST - PEET | -0.07% | ONEVIEW HEALTHCARE PLC-CDI | -0.10% |
| CENTURIA CAPITAL - NATIONAL STORAGE REIT | -0.06% | PRO-PAC PACKAGING LTD | -0.08% |
| AVEO GROUP - STOCKLAND | -0.06% | S&P/ASX 200 INDEX PUT OPTIONS | -0.06% |




## TOP RELATIVE VALUE POSITIONS

- RIO TINTO - RIO TINTO PLC
- CENTURIA METROPOLITAN REIT - GROWTHPOINT PROPERTIES
- OOH!MEDIA - QMS MEDIA
- ADELAIDE BRIGHTON - FLETCHER BUILDING
- AVEO GROUP - GOODMAN GROUP
- ELANOR RETAIL PROPERTY FUND - SHOPPING CENTRES AUSTRALASIA
- BWP TRUST - PEET
- CROMWELL PROPERTY GROUP - PEET
- AVENTUS RETAIL PROPERTY FUND - CHARTER HALL GROUP
- AVEO GROUP - DEXUS PROPERTY GROUP

## TOP SPECIAL SITUATION POSITIONS

- INFIGEN ENERGY
- NUFARM FINANCE NZ LTD-NSS
- S&P/ASX 200 INDEX PUT OPTIONS
- SUNDANCE ENERGY AUSTRALIA LT
- SUPERLOOP LIMITED
- HEALTHSCOPE LTD
- IMPEDIMED LTD
- PRO-PAC PACKAGING LTD
- PARAGON CARE LTD
- GRAINCORP LTD

### Key Information

Fund Inception Date: 3 June 2013

Liquidity: Daily

Management Fee: 1.20%

Performance Fee: 20% of outperformance

Buy/Sell Spread: 0.25%

Application price: $1.1808

Redemption price: $1.1750

Market Neutral Fund AUM: $612.2M

Australian Equity Team AUM: $4.08bn

Firm AUM: Over $6 billion

### Key Service Providers

- Registry: Link Market Services Limited
- Auditor: Ernst & Young
- Prime Broker & Derivative Counterparty: Morgan Stanley Intl & Co PLC
- Administrator: State Street Australia Limited

### Material Matters

During the month there were no material changes to the Fund in terms of its risk profile, investment strategy or changes to investment staff which would impact this strategy. There have been no changes to the key service providers described above.

### Further Information

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