Ellerston Australian Share Fund (ASF)

Performance Report | July 19

PERFORMANCE SUMMARY

Net %	1 Month	3 Months	CYTD	1 Yr	3 Yr p.a.	5 Yr p.a.	Strategy Since Inception p.a.
ASF	6.39	1.00	11.03	-2.41	6.00	5.63	8.86
Benchmark	2.94	8.58	23.25	13.26	11.68	8.55	10.97

Past performance is not a reliable indicator of future performance.

MARKET COMMENTARY

Market Overview

Global equity markets were mixed in July, but Developed Markets outperformed Emerging Markets by 2.1%. A surging US dollar was one of the key factors weighing on Emerging Markets' performance. Global growth concerns, easing monetary policy, renewed trade tensions between the US and China and heightened geopolitical issues in the Middle-East were front and centre and focused investors' attention.

USA

The S&P 500 Index and the Dow Jones Industrial Average Index continued to grind higher in July, returning +1.4% and +1.1% respectively. The NASDAQ rose further, with a return of +2.2% as tech stocks continued their march upwards. In July, approximately half of the S&P500 companies reported quarterly results, with just under 60% beating sales expectations and 78% beating earnings expectations – tech and utilities were the best performing sectors. Earnings were assisted by ongoing buy-back activity.

Economic data was broadly positive - manufacturing PMI came in at 50.6 versus 50.1 expected and payrolls data was stronger too. Despite the escalation of the trade frictions between the US and China towards month end and concerns over slowing growth, the US dollar rallied.

Europe

European equities were rather subdued, with the Euro Stoxx broadly flat in July (returning -0.1%), pulled down by poor performances from the Basic Materials and Oil and Gas sectors. Eurozone economic data was mixed, with unemployment slightly better than expectations, but retail sales were weaker.

The UK's FTSE 100 outperformed in July with a return of +2.2%, buoyed by early optimism from the election of Boris Johnson as the new Prime Minister, coupled with the fall in the GBP. France's CAC 40 returned -0.3% and Germany's DAX returned -1.7%, impacted by fears of slowing growth.

Asia

Asian equities mostly finished the month in the red, with concerns over the renewed trade tensions and a strengthening USD dampening investor enthusiasm. Of the major markets, only Japan's Nikkei 225 was in the black, posting a 1.2% gain. But Korea's KOPSI Composite Index was down almost 5%, the Hang Seng Index was down 2.3% (driven by ongoing civil unrest) and the Chinese SEE Total Market Index was down 0.3%.

Investment Objective

The Investment objective for the Ellerston Australian Share Fund is to outperform the S&P/ASX 200 Accumulation Index (Benchmark).

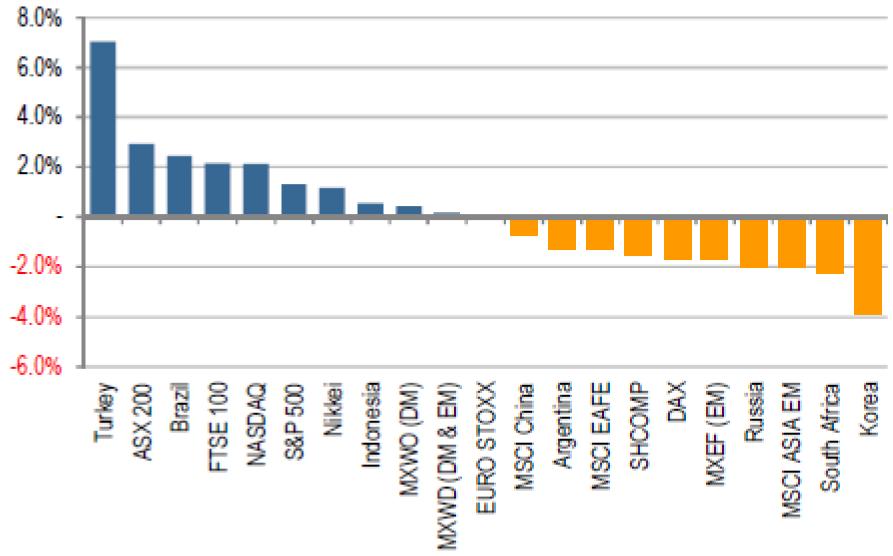
Investment Strategy

The Fund uses a benchmark-independent, high conviction approach that looks beyond investing in the Top 20 stocks in order to capture the neglected opportunities created by under-researched stocks in the broader Australian market.

Key Information

Strategy Inception Date	1 April 2009
Fund Net Asset Value	$0.9452
Liquidity	Daily
Application Price	$0.9476
Redemption Price	$0.9428
No Stocks	20
Management Fee	0.90%
Buy/Sell Spread	0.25%
Performance Fee	15%
Firm AUM	Over $5 Billion

Global Equity Markets' Performance in the month of July 2019

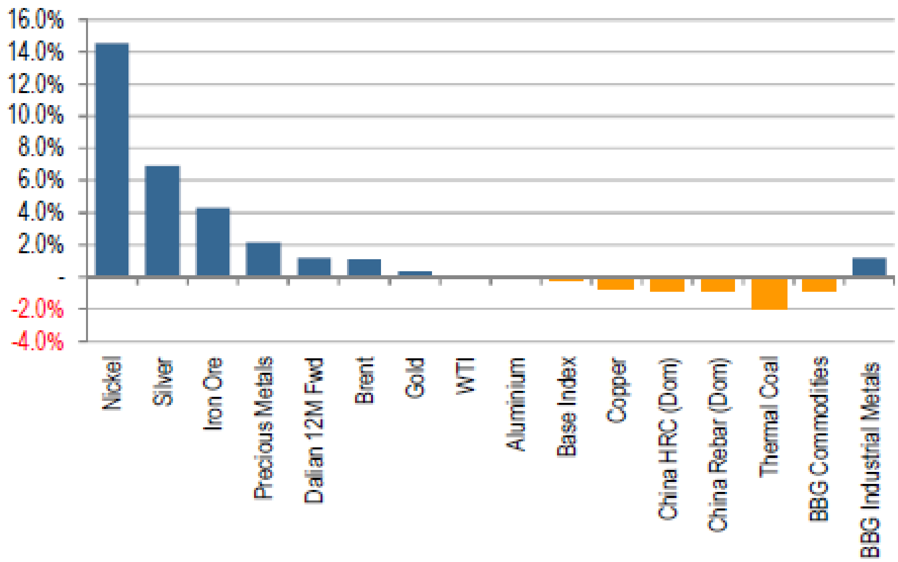


Source: JP Morgan, Bloomberg.

Commodities

Overall, the commodities index slipped in July. Iron Ore was the star performer in July, rising 4.3% to US$120/t. This was the eight consecutive month of gains! Other bulks were mixed with Coking Coal falling 8.2%. In base metals, Copper (-0.8%) had a negative month and has now declined by over 8% in the past 3 months. Also in the base metals complex, Alumina had a terrible month, falling 10.6%, but Nickel was up 14.5%. Escalating tensions in the Middle-East pushed Brent higher in July, up 1.1% to $65.05/bbl.

Commodity Performance in July 2019



Source: JP Morgan, Bloomberg.

Bonds

Continued worries over global growth saw bond yields fall further in July. US 10-year bond yields ended the month at 2.0%, falling by around 50 basis points since April. Economists expect the Fed to continue to cut official rates. In fact, in early August, the Fed cut interest rates by another 25 basis points, taking the US 10-year bond yield sharply below 2.0% at time of writing. In Australia, the RBA also cut official interest rates to 1.0%, sending the Australian 10-year bond yields to an all-time low of 1.19%.

Australia

The S&P/ASX 200 Accumulation Index ended the month up 2.9%, its 7th consecutive month of gains. This index has now returned +23.3% in the calendar year to date, and broke through its previous all-time high of 6829 pts set on November 1st 2007.

In July, the best three performing sectors in terms of their contribution to the index's performance were Financials (+1.7%), Consumer Staples (+9.8%) and Health Care (+5.9%). The bottom three sectors were Utilities (+1.9%), Energy (+1.7%) and Communication Services (+2.9%).

The Small Ordinaries Accumulation Index was the best performer in July (after taking the wooden spoon for the last two months) with a return of +4.5%, while the ASX 200 Resources Accumulation Index lagged, up 1.1%. The ASX 200 Industrials Accumulation Index returned a very credible +3.4%.

The top five stocks that detracted from the performance of the S&P/ASX 200 Accumulation Index were Rio Tinto (-10 points), Woodside Petroleum (-9 points), Fortescue Metals Group (-7 points), BHP Group (-6 points) and AMP (-6 points).

The top five stocks that added to the positive index return were CSL (+37 points), National Australia Bank (+28 points), Wesfarmers (+20 points), Woolworths Group (+18 points) and Newcrest Mining (+16 points). The best performing stocks for the month were in the gold sector, namely Resolute Mining (+32.9%), followed closely by St Barbara (+25.9%), as the A$ bullion price hit a record level.

After holding rates steady for three years, the RBA which cut the cash rate to 1.25% in June, followed that with a further 25 basis cut in July, taking the cash rate to a historic low of 1.00%. Business confidence gave up most of its post-election bounce in June, falling from +7 to +2. Towards the end of the month, RBA Governor Lowe delivered a fairly dovish speech, indicating that the RBA was ready to ease rates further if necessary. The Australian dollar ended the month 2.5% lower against the US dollar at 0.68 cents.

COMPANY SPECIFIC NEWS

The Market Misses

Speedcast International (SDA -45.8%)

SDA kicked off the month with an earnings downgrade as demand for its wireless services got off to a much slower start than expected. It cut its CY19 EBITDA guidance at the mid-point from $166 million to $145 million, or by 13%. The savage sell-off (-46%) reflected concerns around its balance sheet and leverage, given its high debt levels and possible issues with serviceability.

CIMIC Group (CIM -18.0%)

CIM reported 1H19 earnings of $367 million, well below market expectations. Cashflow also disappointed at just $300 million, with cash conversion in the half at just 52%. Whilst mining services remained the bright spot for the group, construction in both Australia and Hong Kong, missed expectations.

AMP Ltd (AMP -15.6%)

AMP's troubles continued in July and this time it was the failure to consummate the sale of its Life business to Resolution which unbalanced the group. RBNZ had issues with the structure of the transaction, wanting more "ring fencing" and suggested it would block the deal. With the cash injection now off the table and surplus capital having seemingly evaporated, the markets focus quickly switched to a potential deeply discounted capital raise.

Pilbara Minerals (PLS -13.8%)

PLS followed up its disappointing sales update from June with an equally disappointing quarterly earnings result in July. Production costs were higher than expected and weak customer demand led to an unwanted build up in inventory through all components of its lithium production process. Weakness in the price of key lithium products is also a material headwind for the share price.

Adelaide Brighton (ABC -12.4%)

Australia's biggest cement maker ABC, shocked the market with a second downgrade, citing weak demand for its cement products across Australia, pointing to the Sydney market in particular. The 25% cut to guidance for CY19, hot on the heels of a hefty downgrade only 3 months ago, coupled with the decision to forego its 1H19 dividend and incur impairments of $100 million for the six months, severely dented investor confidence.

Nearmap Ltd (NEA -10.9%)

NEA pre-announced its headline FY19 numbers which were strong with revenue up 36%. However when trading on 90x EBITDA and unlikely to make a profit before 2021, strong is not always enough. The geospatial mapping company may have another day in the sun at some point, but it could be some time before it retests its recent June highs of $4.29 a share.

Iluka Resources (ILU -10.7%)

ILU had an incredibly strong run during 1H19, rallying from $7 to above $11, as expectations for Chinese stimulus fuelled demand for zircon and rutile. Unfortunately for the Zircon producer, its 1H19 numbers revealed it was hit with lower prices, higher debt levels and poor cash conversion as demand conditions weakened. Profit taking was swift.

Clydesdale Banking Group (CYB -9.4%)

CYB delivered its 3Q19 result which showed Net Interest Margin (NIM) under further pressure, down 7bps for the quarter. NIM for the full year was also guided towards the bottom of its previous range. With Brexit uncertainly hanging over the UK bank, Australian investors were quick to head for the exit door.

Fortescue Metals Group (FMG -7.7%)

FMG gave some of its stellar run back during July, as the iron ore price stabilised. Vale announced that part of its production (Brucutu's 30mtpa) would come back on line in 2H19 which capped the iron ore price run, as shipments from Brazil into China began to recover. That said, with the stock up over 100% since January, it has still been a very good story for shareholders.

The Market Hits

Resolute Mining/ St Barbara (RSG +33.0%/ SBM +25.9%)

RSG agreed to buy Toro Gold for $274 million and announced gold production for FY19 had been better than it anticipated. St Barbara completed the previously announced acquisition of Atlantic Gold and also issued a well-received production report. But the share price rally in these gold stocks and their mining peers was as much about the ongoing rise in the bullion price, up another 3% in AUD terms during July to record levels.

a2 Milk/ Bellamy's (A2M /BAL +23.6%/+21.5%)

Australia's two infant formula producers rallied sharply during the month on the back of broker upgrades and heightened growth expectations, as both companies further penetrate Chinese tier 3 and 4 cities with their infant milk products.

Magellan Financial Group (MFG +21.3%)

MFG continued to defy concerns surrounding the global funds management industry, delivering another strong funds flow performance. FUM jumped approximately 25% in FY19 to hit a record $86 billion with strong retail and institutional flow. Healthy performance fees and upgrades continue to power the group forward.

Elders (ELD +20.2%)

ELD announced the acquisition of Australian Independent Rural Retailers in July, a transaction that the market embraced. With synergies, the acquisition was double digit EPS enhancing and reminded the street that the sector remains ripe for consolidation.

Nufarm (NUF +19.0%)

Nufarm appeared to turn the corner in July as fears of glyphosate litigation eased and speculation appeared in the press about potential US private equity interest in the group.

Treasury Wine Estates (TWE +18.6%)

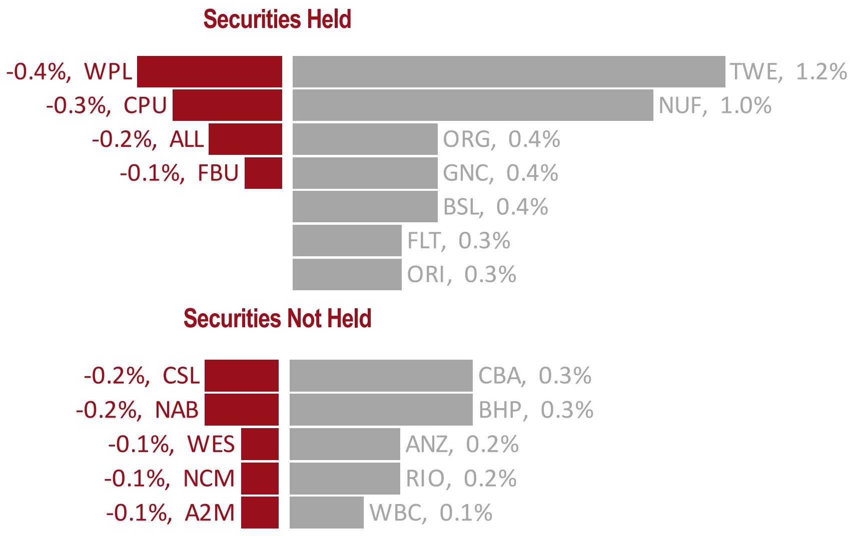
Positive data release by Wine Australia during the month showed a jump in bottled exports to Australia's key wine markets of China and USA. Whilst market attention is focussed on the key Chinese market, TWE in fact showed the strongest growth in its USA based business in over 2 years, fuelling excitement that its route to market changes in the USA are working.

FUND PERFORMANCE

Kicking off the new financial year on a more positive note, the Fund experienced strong performance across many of its key holdings. This coupled with weaknesses in the areas we have tended to avoid has resulted in the Fund delivering a solid return of +6.49%, outperforming the Benchmark return of 2.94% for the month of July.

RETURNS[1] (%)	GROSS	BENCHMARK*	EXCESS	NET
1 MONTH	6.49	2.94	3.55	6.39
3 MONTHS	1.28	8.58	-7.30	1.00
CYTD	11.74	23.25	-11.51	11.03
ROLLING 12 MONTHS	-1.33	13.26	-14.59	-2.41
3 YEARS (P.A.)	7.13	11.68	-4.55	6.00
5 YEARS (P.A.)	6.77	8.55	-1.78	5.63
SINCE INCEPTION (P.A.)	10.04	10.97	-0.93	8.86

Past performance is not a reliable indicator of future performance.



Source: Ellerston Capital..

The main positive contributors to this month's performance were overweight positions in Treasury Wine Estates (TWE +18.6%), Nufarm (NUF +19.0%), Origin Energy (ORG +8.6%), Bluescope Steel (BSL +8.6%), Flight Centre (FLT + 10.9%) and Orica (ORI +7.7%).

Having zero holdings in the big banks and the miners were also a reasonable contributor to performance, with Commonwealth Bank of Australia (CBA -0.6%), BHP Group (BHP -1.0%), ANZ Banking Group (ANZ -1.1%), Rio Tinto (RIO -4.7%) and Westpac Banking Group (WBC +1.0%) all underperforming the market.

The main detractors were overweight positions in Woodside (WPL -4.6%), Computershare (CPU -2.3%), and Aristocrat Leisure (ALL -0.2%).

Having a zero holding in CSL (CSL +6.8), National Australia Bank (NAB +6.7%) Westfarmers (WES +8.4%), Newcrest (NCM +11.4%) and A2 Milk (A2M +23.6) also constrained returns.

[1] The return figures are calculated using the redemption price for Class A Units and on the basis that distributions are reinvested. The Gross and Excess return figures are before fees and expenses whereas the Net Return figures are net of fees and expenses for the Class A Units. Returns of the Fund may include audited and un-audited results. Past performance is not a reliable indicator of future performance.
* The benchmark was changed from the S&P/ASX 200 Accumulation Ex REITS Index to the S&P/ASX 200 Accumulation Index on 1 July 2012.

FUND ACTIVITY

In July the fund was highly active as we strengthen Core positions (Treasury Wine Estates, Orica, Woodside Petroleum and Flight Centre), took profits in JB Hi-Fi and Ooh Media and reduced the fund's position in Fletcher Building, Star Entertainment, Origin Energy and IOOF Holdings. See more detailed updates below.

We have also provided a timely write-up on Orica (after the activity section) following its investor day update in July.

NEW STOCKS ADDED	STOCKS EXITED
• Caltex Australia	• Star Entertainment Group

POSITIONS INCREASED	POSITIONS DECREASED
• Treasury Wine Estates	• JB Hi-Fi
• Orica	• Fletcher Building
• Woodside Petroleum	• IOOF Holdings
	• oOh!Media
	• Origin Energy

Caltex

Investment Thesis

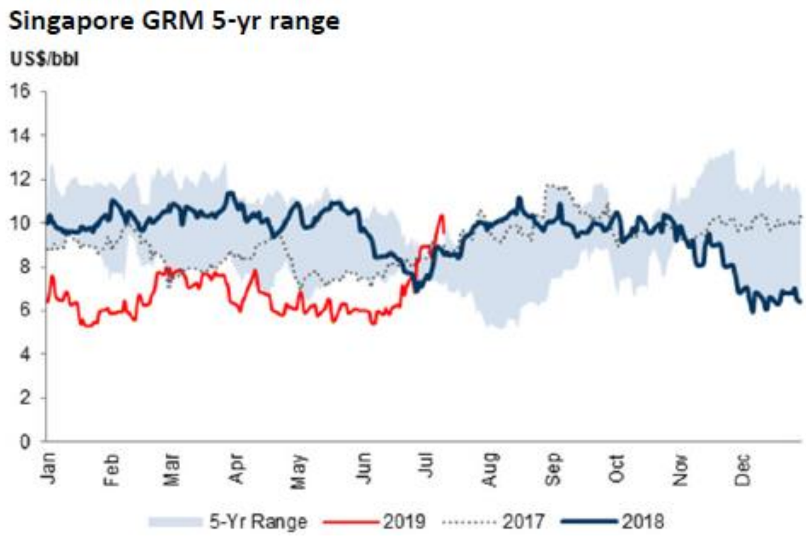
Caltex was introduced to the portfolio in the month of July. The company effectively runs 3 distinct but inter-linked operations. Refining; Fuels and Infrastructure; and a Retail Convenience network. All three divisions have been under pressure over the last 18 months and the company has significantly underperformed for a longer period. We believe the issues in refining and retail convenience should prove transitional, providing the fund with an excellent entry point.

Refining

CTX owns and operates the Lytton Refinery located in the port of Brisbane, with nameplate production volume of 6.3bn litres. The key driver of profitability at Lytton is gasoline and diesel crack spreads.

Crack Spreads are notoriously volatile and difficult to predict

Crack spreads, which remain extremely difficult to predict, impacts Caltex's refiner margin. Over the last 5 years, refining margins have traded in a range generally between US$9 and US$12 a barrel, however tracked aggressively south at the backend of 2018 and 1H19 as highlighted in the chart below. Earnings downgrades for the sector flowed and with it CTX's rating. We believe that the strong recovery seen in July is a key inflection point.



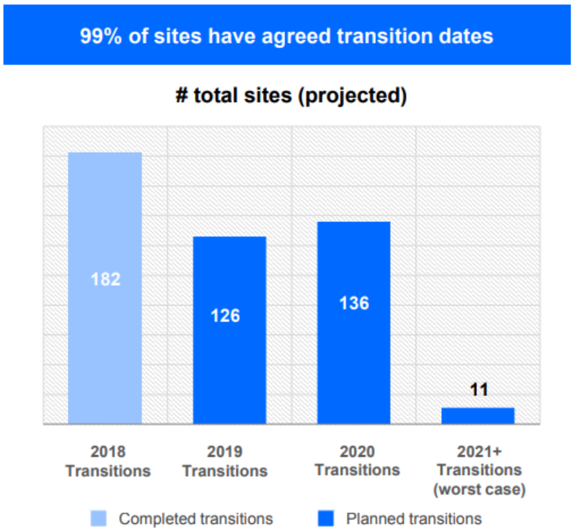
Source: Goldman Sachs Research.

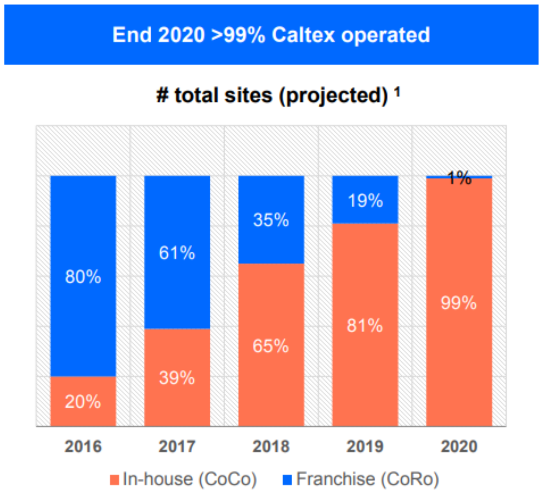
Girard Point closure lifts all boats
As things began to look desperate for the refining sector, Philadelphia Energy Solutions (PES) announced on June 21 that is was permanently closing its refinery at Girard Point after it was completely destroyed by fire. Girard Point was the largest refinery on the East Coast of the US, producing 300k barrels per day and its closure could meaningfully change the supply landscape.

Fuels and Infrastructure (F&I)
CTX's F&I operation is predominantly a B2B business servicing over 80,000 customers in a wide range of industries including the transport, agriculture, mining and construction. It includes 94 bulk fuel storage and distribution hubs, with over 300km of fuel pipelines.

F&I is the jewel in the CTX's operating portfolio as its scale advantages make it the go to player domestically for significant fuel needs. Domestic fuel demand lifted 4% in CY18 and **CTX grew significantly faster at 10%,** underscoring its ability to win share.

Retail Convenience (RC)
CTX has over 800 sites across the country and is rapidly in-housing the remaining franchisee controlled sites. In 2018 CTX transitioned 182 sites into company ownership and has approximately 270 sites still with franchisees. By the end of 2020, 99% of fuel sites will be in-house which should provide the company with greater operational flexibility. CTX's property portfolio is worth more than A$2 billion and provides optionality.





Source: Company Data

RC remains a conundrum for CTX. The company has dabbled in various product formats to entice customers to its forecourt which appear to lack cohesion. In fact the company appears to be somewhat lost in delivering the strategy.

Below is an excerpt from its annual report published less than 3 months before its recent profit warning in June. "*We have put the foundations in place that will drive our future success – in 2018 we have defined our core retail formats, invested in IT to deliver unrivalled customer service, taken steps to deliver consistent experience across our network with the transition from franchise to company-owned sites and progressed our strategic partnership with Woolworths, which will be an important part of our future.* ***We head into 2019 with momentum and are focused on executing our growth strategy***."

What went wrong in 1H19?
CTX was hit with the perfect storm in RC, significantly impacted profitability. A surging oil price, a weakening A$, a cautious consumer and a more competitive market place all combined to significantly impact earnings. Indeed at CTX's 1H19 update last month, the company guided that earnings would halve to ~$80m from $161m in 1H18, taking the market by huge surprise.

Critical questions remain. How much of the impact can be attributed to in-housing? How much is management change? And most importantly…how quickly will profits recover? Like many industries in Australia, fuel retailing is concentrated. A disciplined 3-4 player market where the incentive is to protect margins remains the underlying backdrop. However the easy gains from Viva/Coles have gone and discipline will be required to re-align the industry. This will be critical to monitor…

SOTP Valuation and Financials

Fuels & Infrastructure is the jewel in the CTX crown and we have given it a premium multiple of 9x, but in-line with peers in Europe.

Refining has averaged EBITDA of $260m over the last 5 years since the shut-down of Kurnell, with a high in 2017 of $388m. Our multiple of 7x reflects the volatility of the earnings and peer comps.

Retail Convenience remains a very difficult business to value. Our FY20 numbers are below the street and the multiple of 8x EBITDA is below global peers and local supermarket multiples. We are being conservative here.

SOTP valuation			
	EBITDA	Multiple	Valuation
Non-Lytton F&I	537	9	4,831
Convenience Retail	446	8	3,569
Refining	245	7	1,718
Corporate costs	-65	8	- 520
Total	**1163**		**9,598**
Net debt (incl capitalised lease costs)			- 1,901
Equity value			**7,697**
Equity value per share			**30.79**

Source: Ellerston Capital Limited

Key risks to our thesis

- The closure of Gerard Point provides a short-term boost to refining margins and they quickly fall again.
- Retail Convenience does not recover as the market adjusts to Viva and Coles pursuing market share.
- New management look to re-set the strategy again.

oOh!Media

The portfolio exposure to oOh!Media (OML) was more than halved late in the month as the share price spiked to 7 month highs and touched $4.60. We continue to hold a position, given our positive view of the medium-to longer-term growth prospects. The out-of-home (OOH) advertising sector is still seeing steady growth in audiences (unlike most other traditional advertising platforms) and advertising dollars normally follow the eyeballs. As previously articulated in our original investment thesis when the stock was completely bombed out and purchased in mid-March 2019, the digitisation of panels increases the revenue per site by 3-5 times the pre-existing static billboard that is replaced. This is done for a modest capex investment and hundreds of Adshel billboards will be digitised over the next 2-3 years. The industry consolidation to two main players, OML and JC Decaux, with similar market shares, should result in more rational behaviour when it comes to bidding for sites and advertiser tenders. Significant operating leverage will also start to emerge as OML banks the synergies that derive from the acquisition of Adshel.

OML has performed very well since we initiated the position at around $3.82 and at the end of July, was trading at over $4.50. The valuation is now closer to fair than cheap, trading on 14.7x next 12 month earnings compared to 12.9x when we first bought the stock. We would expect management to reiterate earnings guidance for CY19 (EBITDA $152-162m) when they report their half year results on 26 August 2019. Industry data implied a solid 5% growth in revenues for the OOH industry in the June half. But the softness in the overall advertising market and boarder economy has probably reduced the potential for an imminent earnings upgrade, with the seasonally skewed December half still ahead of it.

We will be ready to add to our newly right sized position if an unwarranted share price correction was to occur or, alternatively, in the absence of any new information, reduce the exposure further if the share price continues to re-rate above what we see as fair-to-full valuation at $4.60.

Fletcher Building

During the month, we reduced your holding in Fletcher Building (FBU) and ceased to be substantial in the name. FBU is a company that has failed to meet our expectations and whilst its valuation multiples appear cheap, there could be further downside risks in the stock. As a reminder, having just totally exited Boral at near highs, our initial investment thesis on Fletcher Building was that the new CEO at the time, Ross Taylor, who had significant experience with large construction projects (ex UGL), was capable of managing FBU's problematic B+I (Building + Interiors) construction book, which caused the sell-off in its share price. At the same time, we felt that FBU had non-core assets that could be divested in order to significantly repair its balance sheet. These catalysts have now mostly played out.

Fletcher Building did in fact contain the B+I EBIT loss to NZ$660m in FY18 as per expectations and sold the Roof Tile Group and Formica for top dollar to generate net sale proceeds of NZ$1.2bn. Furthermore, the company has recently announced a NZ$300m on market buyback that will commence after the FY19 results announcement this month.

With the key catalysts largely having played out, we believe there are downside risks from here. Firstly, since our initial investment, the macro backdrop for both Australia and New Zealand has proven more challenging and this was evident when management pointed to "a sharp decline in the residential market" as one of the key reasons for FY19's halving of Australian EBIT to NZ $55m. Management presented positively at its investor day held in Sydney on its initiatives and turnaround prospects of the Australian business. A cost-out programme with hard benefit targets of $100m gross ($50m net) by FY21 was enunciated. However despite some of the earlier initiatives starting to pay off, they have been offset by a very difficult market and macro headwinds, hence the need to go much harder on costs. While New Zealand has been more resilient and the core business is operating well, there are leading indicators suggesting some downside risk e.g. housing sales and average days to sell have fallen to the lowest levels since 2011/2012.

Secondly, it is becoming evident that a combination of intense competition and cost pressures are constraining margins. Some examples of increasing competitive threats include: USG-Boral's plasterboard push in NZ, cement imports and Steel & Tube's pursuit of market share. We expect FBU will face cost pressures in NZ given the continued tight, albeit modestly softening, labour market (companies continue to report both difficulty in finding skilled and unskilled labour, and difficulty in passing on rising costs), increasing minimum wage +6.6% pa to NZ$20/hour by 2020, additional fuel taxes, and regulatory and compliance costs.

In conclusion, with NZ and Australia unlikely to show signs of meaningful upside over the next 6-12 months, we have tempered our view and have downsized the position, with a strategy of exiting. Market expectations for FY20 should more or less be on target as management have already stated that it expects "slightly softer but still healthy market conditions in NZ, and ongoing contraction in the key residential market in Australia", however we cannot rule out softer guidance as per the reasons above and are not prepared to take that risk.

Star Entertainment

We immediately reduced the exposure to Star Entertainment in your portfolio early in the month after the shares recovered from their sharp sell-off in early June, caused by the sharp deterioration in performance of its mass market business.

Star Entertainment had a very strong December 2018 half, with both slots revenue +6.3% and mass tables +6.4% showing encouraging trends. In February, the company indicated that revenue momentum continued into the start of the June 2019 half. Disappointingly, that momentum was not sustained beyond February. Mass market revenue growth dropped away significantly in March and April and is yet to recover. Consequently, Star Entertainment surprised us and the market by issuing a very underwhelming earnings update in early June, where it disclosed slots revenue growth in the June half to date of only +1.6% and mass tables growth turning negative (-0.8%).

While we were wary of the weakness in the housing market (which has been soft for a while) and its historic correlation with casino revenues, we expected that the stable employment market, modest disposable income growth and the ramp up of new hotel and gaming facilities at the Gold Coast and Sydney properties would be sufficient to sustain relatively strong revenue growth for the group. This has not been the case. With no sign of an improvement in consumer sentiment or economic conditions in the near term, we reduced our revenue growth expectations.

Compounding the weak mass market has been continued weakness in VIP revenues, which failed to recover and were down 31% on the same period last year. The trade war and geopolitical tensions have given the gambling 'whales' reason to stay home, visit casino competitors in other jurisdictions or gamble less when they do come to Australia.

Star Entertainment positives included:

- The company announced a significant head count reduction from the consolidation of back office services across its three main properties that will deliver $40-50m in annual benefits by FY21, equivalent to ~8% of FY19 EBITDA
- The new Queens Wharf casino it is building in Brisbane should deliver a positive step change in earnings when it opens in 2022
- Approximately 60% of the $2.4b construction cost for the new Brisbane casino has been locked in, with the remainder to be contracted over the coming 6-12 months in what is an improving construction tender environment for property owners in SE Qld
- Annual capex is already trending down as Star Entertainment utilises its Chinese partners, Chow Tai Fook and Far East Consortium, to partly fund the expansion of non-gaming facilities - important drivers of traffic to the casino floor, but relative low returning on a stand-alone basis
- The new premium gaming room (Sovereign Room) in Sydney will open in the new year and should deliver an uplift to revenue growth
- The company continues to look cheap trading on 15.5x FY20 earnings, well below the Industrials ex Financials multiple of 23x and near historic lows
- Pending regulatory approval for the Chinese partners to increase their ownership stake to 20% from the current 10% via on-market purchases.

But the lack of revenue momentum and our reduced level of confidence in the management team's ability to execute cannot be ignored, especially with competition from Crown Sydney rapidly approaching (early 2021) and the threat of a second Gold Coast casino likely to linger for another six months.

More concerning, Star Entertainment is also likely to suffer from collateral damage following the extensive negative media coverage in late July surrounding casino peer, Crown Resorts and the operation of its high roller business. Whilst Star Entertainment has not been specifically named in reports, it is probable that all operators in the region are likely to experience a decline in VIP player visitation, at least in the short-term. This was the case when the Crown Resorts staff were suddenly arrested in China back in 2016. There is also an increased risk that long-term VIP players are curtailed from tighter visa approval processes and the potential introduction of more onerous 'junket' probity conditions and regulatory scrutiny.

In light of the abovementioned trends and risks, we think we can find better opportunities to deploy your capital elsewhere in the near term and at the time of writing, have exited the small residual position left from month end.

Orica

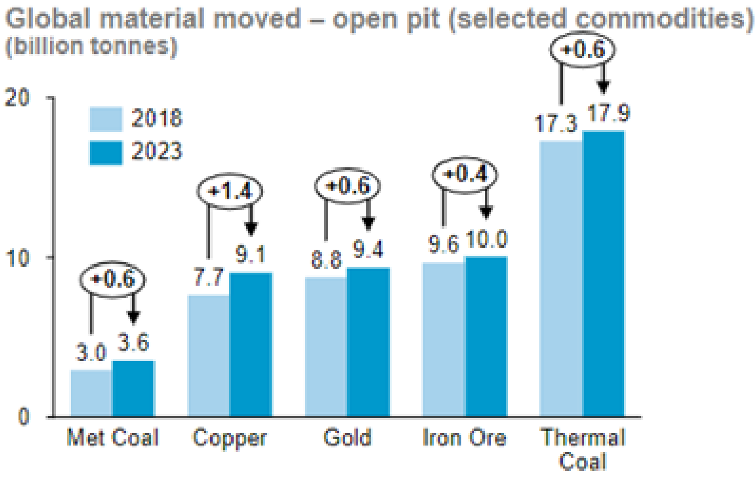
Investor Day Update – July 2019

Towards month end, Orica (ORI) hosted its first Investor Day since 2015, showcasing its next leg of growth which encompasses investments in digital, wireless automation and monitoring (GroundProbe). In addition, management provided an encouraging update on the outlook for each region, as well as the turnaround in manufacturing, including progress on Burrup's rectification. Our key takeaways are below:

Overall explosives backdrop

As the world's largest provider of explosives and services, ORI is uniquely positioned to take advantage of rising mining volumes and more importantly, in more complex geographic settings. For example, blasting in extreme hot (100 degree Celsius geothermal hot grounds in Indonesia) or cold conditions (polar far north Russia), extreme altitudes (5200m in Kyrgyzstan) and at depths (100m+ underground in Latin America).

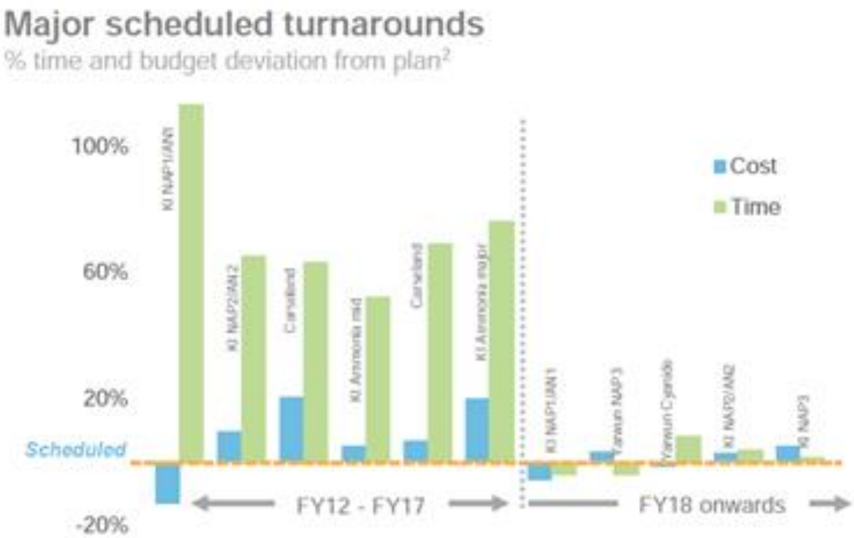
In ORI's largest market, Australia Pacific & Asia, ammonium nitrate (AN) demand is now outstripping commodity growth, leading to AN prices (IPP) increasing ~10% over the past 12 months. This has been exacerbated by recent anti-dumping measures in Australia. ORI noted that the East coast market is now currently in balance and that Yarwun has capacity to ramp up production in line with QLD demand. We expect ORI to materially benefit from higher AN prices as contracts are renewed post FY21. **Overall, management presented an upbeat outlook and confident tone, with each region expecting to see increased EBIT and the company reaffirmed previous outlook commentary regarding FY19 and FY20.**



Source: Company Data

Manufacturing and Burrup

One of the key market concerns has been the reliability of ORI's manufacturing base and in particular the rectification of the problematic Burrup plant operated by Norwegian group Yara. Group Executive Manufacturing & Supply, Carlos Duarte, (ex 30 years Schlumberger) has set a goal to have >80% Overall Equipment Effectiveness (OEE) in all plants. There appears to be early evidence of success, including demonstrable gains on turnaround times and keeping within budget, while daily production rates have improved post turnaround (refer chart below).



Source: Company Data

In relation to Burrup, the company is now more confident around a permanent fix, both from a timing (FY20: 50% OEE) and budget perspective ($40m net of $120m performance bond). More specifically, management stated that 5 of the 9 new heat exchangers had already been delivered, whilst another 3 were in transit, with the final exchanger due to be despatched in coming weeks. Cold commissioning is scheduled around Dec/Jan and hot commissioning in February 2020, with the plant to be fully online by March 2020. Importantly, ORI noted that it had produced 40kt of good quality AN during a plant test in May following temporary repairs, suggesting that no further material issues have been identified.

Technology

ORI's next growth phase will be underpinned by technological innovation: wireless blasting, digital blasting data/analytics and monitoring/measurement. ORI's wireless blasting detonation product (WebGen100) is generating growing market interest with c.220 blasts fired globally and customers reporting +34% ore recovery and +20% productivity improvements. The BlastIQ digital blasting data platform has now been adopted by 25 customers across 35 mining sites, (measuring tailings dam wall movements and mining stability) improving mine productivity by 5% and reducing drill costs by 10%. GroundProbe, a critical monitoring technology business acquired for $205m in 2017, has been a highly successful investment. Management are expecting earnings to be 70% higher in FY19 than the original investment case and a 15% RONA hurdle to be achieved in the second full year of ownership (vs. 3-5 years initially).

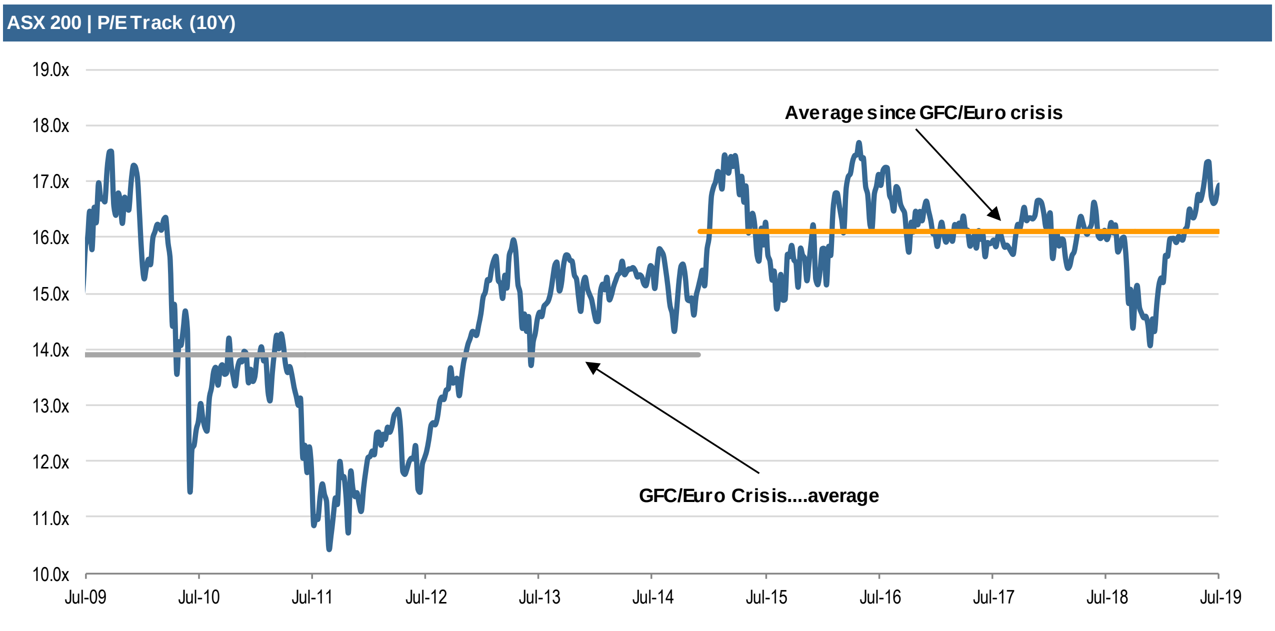
Conclusion

We walked away from the investor day (and the 90 pages of presentation material) incrementally more positive. In our view, with the transformation of the core business gaining momentum, ORI's FY19-21 earnings growth outlook looks firmly underpinned by the organic means (delivery of new mining customers and increased take-up by existing customers) and market share gains. Beyond this, the company expects its High Growth technology product portfolio to power its next leg of growth. If ORI management can execute, the industry will move to a much higher technology threshold, lifting barriers to entry and improving returns. Investor attention is thus likely to shift to FY21, where operating leverage coupled with technology margin pass-through will really start to drive earnings.

FUND STRATEGY AND OUTLOOK

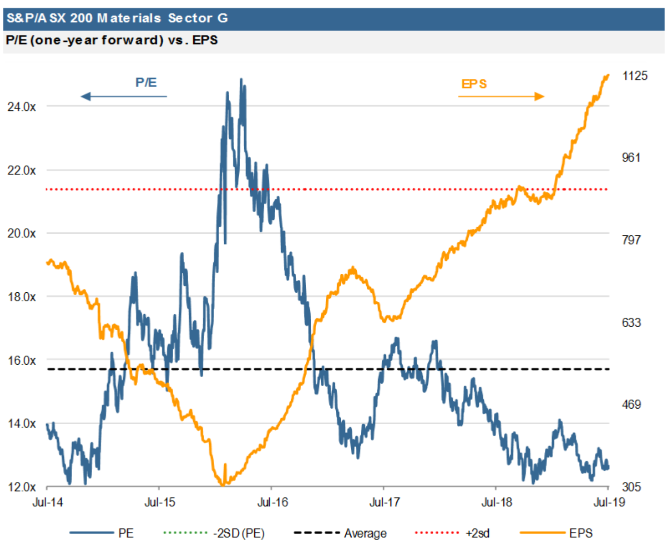
With the tempest of reporting season upon us, we approach this earnings round against the backdrop of the best CYTD market performance since 1991 (up 23.3%). We remain committed to our bottom up, stock focussed strategy as we seek to identify mispriced stocks where medium to longer term earnings growth is underappreciated.

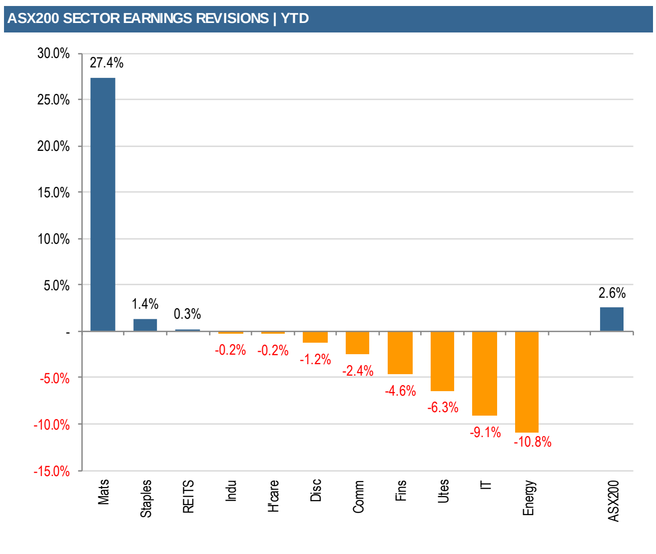
We have expressed concerns on the sustainability of earnings and the forward PE multiple of the market in recent updates, and provide more context below. In the period post the GFC and the Euro crisis, the ASX 200 has traded in a range of circa 2.5 PE points, 15.0x and 17.5x. Its current level is within that band at 16.8x (see chart below). The index did trade much lower in the wake of the GFC and subsequently through the Euro crisis – a period distinct to the last 5 years.



Source: J.P. Morgan, 31 July 2019.

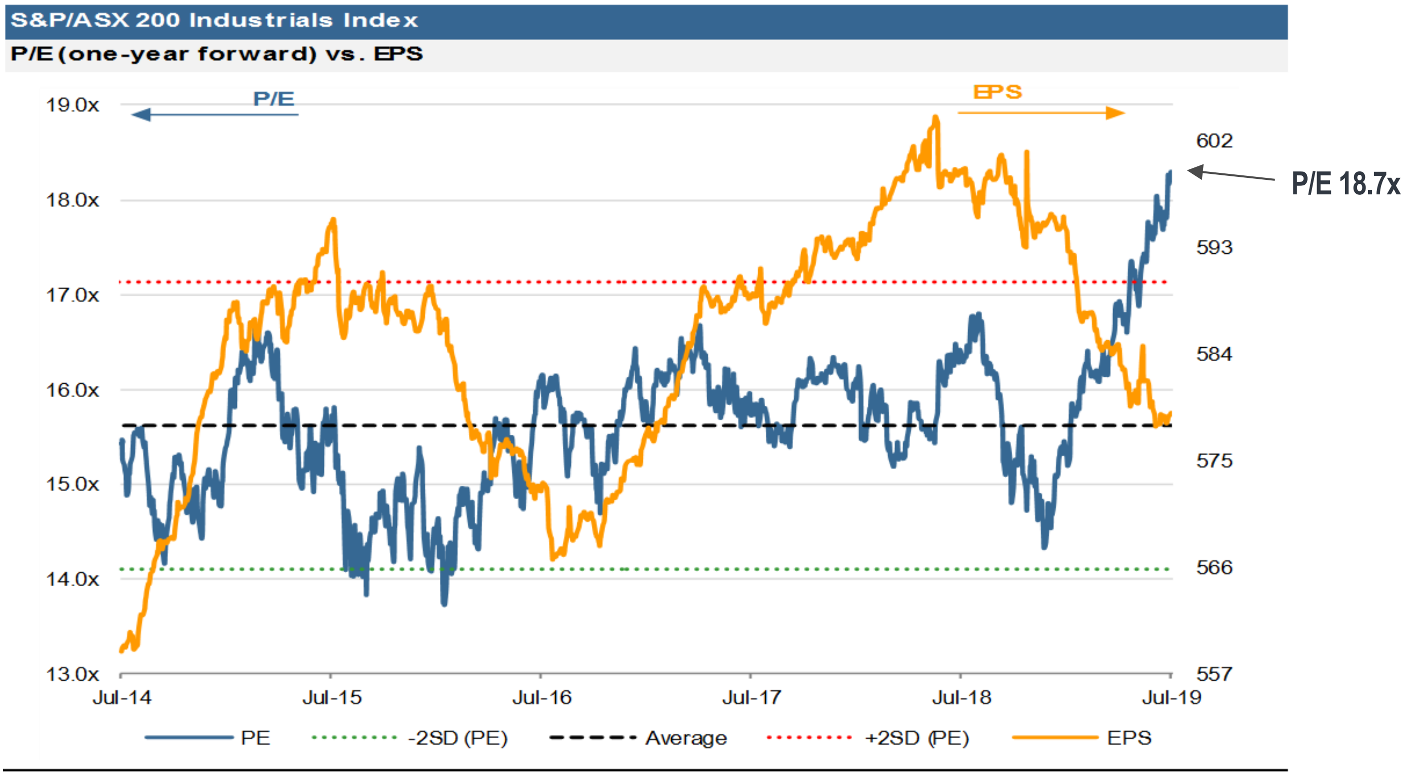
The chart suggests that the market is at fair value, especially in the context of the increasingly vocal debate on sustained lower interest rates and therefore, a lower implied cost of capital. However, **current headline EPS forecasts are distorted by the disproportionate contribution of the materials sector**. When we strip out the contribution of the materials sectors (supported by very high Iron Ore prices – now correcting), the optically compelling EPS picture for Australia is more illusory. The mining sector is responsible for the entire uplift in the market's earnings going forward. Similarly, the bulk of the updates in earnings forecasts for staples comes from one stock – A2 Milk. The charts below bring this argument to life.





Source: J.P. Morgan, Bloomberg.

If we remove mining (where unsustainably high Iron Ore prices are being capitalised by the market) from the market's earnings, domestic equities are far more stretched in terms of valuation than the headline PE would suggest. On a 1-year forward basis, the ASX 200 ex Materials and Energy is trading almost 3 sigma deviations above the 5-year average. It is now in record high territory (see chart below).

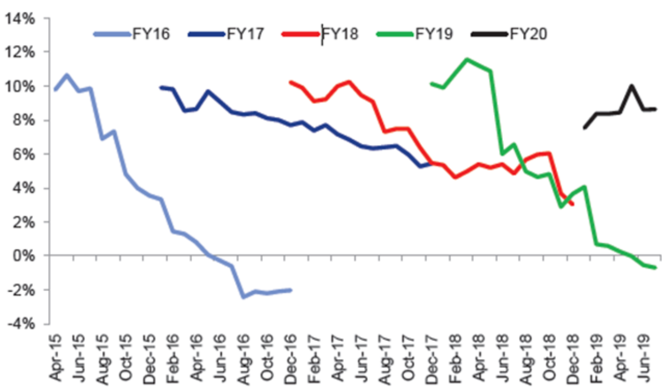


Source: J.P. Morgan, Bloomberg.

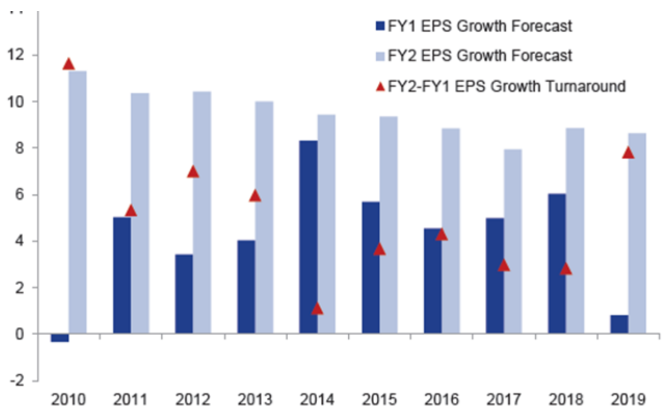
Despite weaker economic data and numerous profit downgrades this year, the market has rallied, taking its lead from global markets as central banks (including the RBA) become more dovish in anticipation of slower global growth. There is little evidence currently that economic momentum is turning more positive, especially as renewed trade wars put downward pressure on growth.

Earnings forecasts continue to look optimistic. Against a weaker economic backdrop and the distorting effect of materials, we expect earnings forecasts to follow the pattern of the past few years. Twelve months ago, the expected EPS growth for the ASX 200 was ~9%, it is now broadly flat (see chart on the left below) and declining as we go forward.

ASX200 Industrials Earnings Growth Revisions



Biggest turnaround in earnings growth expected since 2010



Source: Factset, Goldman Sachs Research.

Our near-term trepidation on the Australian market revolves around earnings, given 80% of this year's rally has been driven by PER expansion.

With the next 10% round of US tariffs on US$300 billion of Chinese imports to take effect on 1 September 2019, investors are starting to grasp the potential for a protracted conflict and for trade protectionism to intensify further. Given this quagmire and no clear path to a resolution in an already weakening global economy, we remain cautious on markets and hold elevated cash levels at months end.

But again, to summarise your portfolio's positioning.

1. Quality Franchises

Solid companies with strong/leading market positions and credible management with good balance sheets

Macquarie Bank, Computershare, Treasury Wines and Aristocrat

2. Businesses that are highly cyclical or seasonal in nature, facing certain headwinds

Companies with strong market positions and strategic assets, but very sensitive to economic conditions/seasonality/weather

Graincorp, Nufarm, JB Hi-Fi, Downer EDI, Flight Centre and Ooh Media

3. Turnarounds

Sound businesses that have historically generated poor returns, have been poorly managed, under-earned versus their potential, are in transition, and where we think earnings/returns will improve over the medium term. Out of favour with the market, somewhat contrarian positions

Caltex, Orica, QBE and Janus Henderson

4. Deep Value Cyclical and Resource Plays

Stocks trading at discounts to NPVs, or with growth optionality, where much of the heavy lifting has been done (cost out, self help)

BlueScope Steel, Woodside Petroleum and Origin Energy

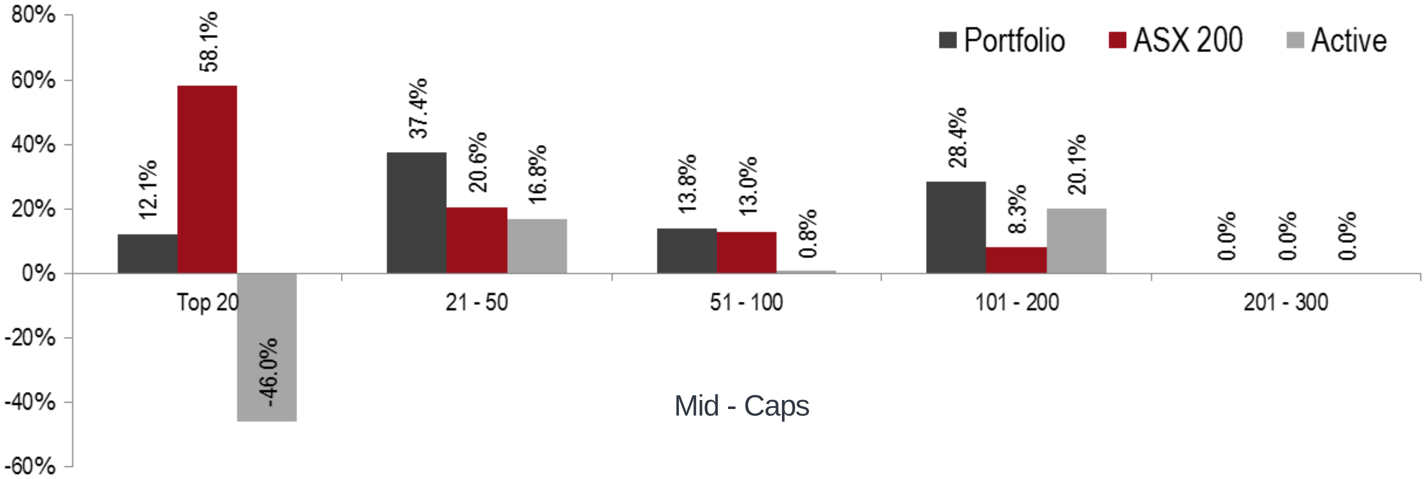
Still **Zero Big Four Banks**

Warm Regards,

Chris Kourtis
Portfolio Manager

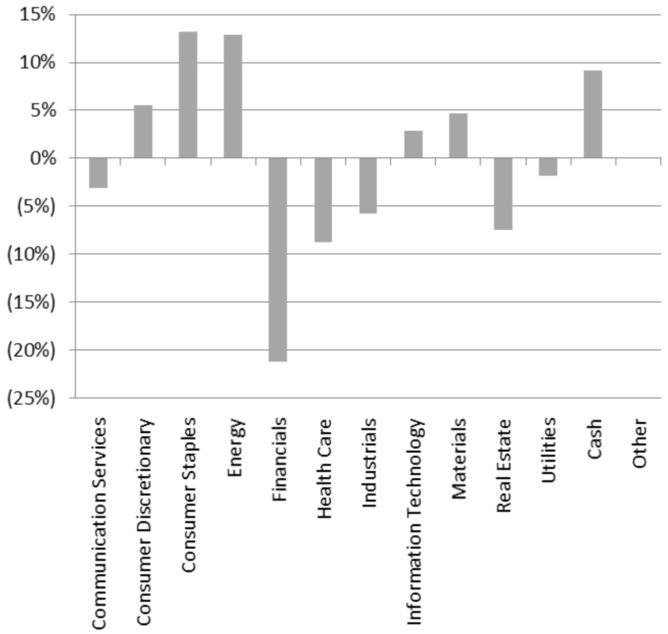
PORTFOLIO FEATURES

Size comparison Chart vs ASX 200^



^Size Comparison Data as at 26 July 2019
Source: Bloomberg, Ellerston Capital Limited

Active Sector Exposures*



Source: Ellerston Capital Limited

TOP 10 HOLDINGS**
ARISTOCRAT LEISURE
BLUESCOPE STEEL
COMPUTERSHARE
GRAINCORP
MACQUARIE GROUP
NUFARM
ORICA
ORIGIN ENERGY
TREASURY WINE ESTATES
WOODSIDE PETROLEUM

* 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.

** Top 10 Holdings are listed in alphabetical order.

ABOUT THE ELLERSTON AUSTRALIAN SHARE FUND

The Fund aims to achieve its performance objectives by adopting a fundamental "bottom-up" investment approach to stock selection which is focused on identifying and then constructing a portfolio of the highest conviction ideas.

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.

Due to the high conviction nature of the portfolio and the resulting deviation in portfolio composition relative to benchmark weighting, it is expected that the returns from the Fund will differ significantly from the broader market indices.

FUND FACTS

STRATEGY FUNDS UNDER MANAGEMENT	$3.4 BILLION
FUNDS UNDER MANAGEMENT – ASF UNIT TRUST	$50 MILLION
APPLICATION PRICE	$0.9476
REDEMPTION PRICE	$0.9428
NUMBER OF STOCKS	20
INCEPTION DATE	1 APRIL 2009

Source: Ellerston Capital Limited

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