Ellerston Capital

Ellerston Australian Micro Cap Fund

Performance Report | August 19

PERFORMANCE SUMMARY

Performance	1 Month	3 Months	6 Months	1 Year	2 Year p.a.	Since Inception (p.a.)
Net^	0.52%	7.87%	17.55%	11.78%	13.48%	20.06%
Benchmark*	-3.85%	1.41%	4.14%	0.95%	11.12%	10.83%
Alpha	4.37%	6.46%	13.41%	10.83%	2.36%	9.23%

Source: Ellerston Capital

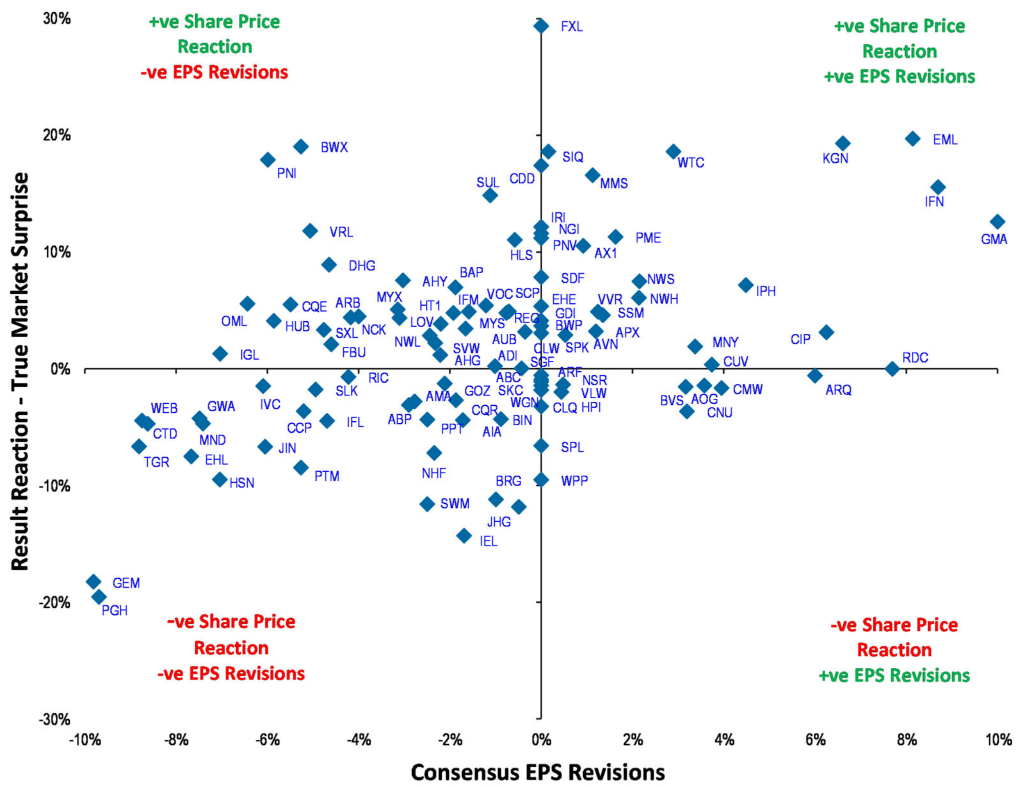
^ The net return figure is calculated after fees & expenses. Past performance is not a reliable indication of future performance

* S&P/ASX Small Ordinaries Accumulation Index

COMMENTARY

For the month of August the Ellerston Micro Cap Fund delivered 0.52%, outperforming the Small Ordinaries Accumulation index by 4.37%. If we look at the Small Industrials constituents which reported (135 companies), 66 companies saw downward consensus EPS revisions, compared to only 21 companies that saw upward consensus EPS revisions. As the exhibit below outlines there were a few exceptions to this rule, where companies that produced quality results which resulted in positive consensus EPS revisions, rallied strongly.

ASX Small Industrials – Reporting Season August 2019



Source: JP Morgan

Investment Objective

To provide investors with long term capital growth via investing in a portfolio of quality Australian & New Zealand Micro Cap companies. The fund aims to outperform the S&P/ASX Small Ordinaries Accumulation Index over the medium to long term.

Investment Strategy

The Fund employs an active, research-driven investment approach which seeks to identify and invest in companies that are believed to have the potential to deliver significant upside over the medium term and where there is a reasonable margin of safety to mitigate downside risk. Positions are actively managed within the Fund.

Key Information

Strategy Inception	1 May 2017
Portfolio Manager	David Keelan & Alexandra Clarke
Application Price	$1.3914
Net Asset Value	$1.3879
Redemption Price	$1.3844
Liquidity	Daily
No Stocks	55
Management Fee	1.20%
Performance Fee	20%
Buy/Sell Spread	0.25%/0.25%

Ellerston Capital Limited
ABN 34 110 397 674
AFSL 283 000

Level 11
179 Elizabeth Street
Sydney NSW 2000

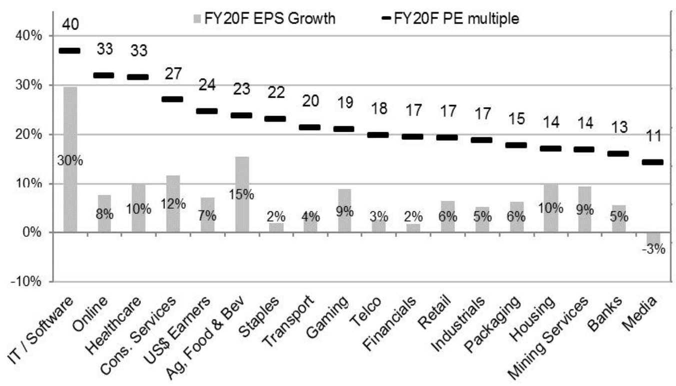
Ph: +61 2 9021 7797
Fax: +61 2 9261 0528

info@ellerstoncapital.com
www.ellerstoncapital.com

APIR Code: ECL0984AU

As we delve deeper into reporting season and examine sector specifics, we saw Retailers enjoy a good bounce with numerous operators flagging a rebound in consumer sentiment (JB Hi-Fi, Accent Group and Super Retail Group to name a few). Another phenomenon was the online platform players (Seek, Realestate.com and Domain) which are trading at exceptionally elevated PE's, saw significant negative FY20 EPS revisions (3-28%). Despite earnings being cut, the share prices rallied strongly, which in our view was on the back of top-line growth. Given the low interest rate environment we are also seeing IT/Software players' PEs continue to expand with this segment now trading on an FY20 PE of c40x compared to the market which trades on a one-year forward PE of 19.2x (a substantial premium to its 5 year average).

Sector earnings growth versus 12m forward PE multiple



Source: Morgans

Key themes to emerge during August include:

Improved sentiment towards housing: We saw sentiment in housing related stocks starting to improve, albeit off a low base. While most acknowledged that we are in a low growth environment, clearance rates have started to improve with the stabilisation of house prices. This has resulted in some green shoots in outlook commentary from the likes of Adair, JB-Hi-Fi and Beacon. We will be keeping a close watch on this sentiment as we determine what is a post-Election rally, tax return and impact from the Government cash handouts versus a structural rebasing of the sector.

Pockets of growth in offshore earners: As we touched on in our July monthly, we believed companies with offshore earnings would be rewarded by a lower AUD/USD. What occurred during August was the fact that companies exposed to Trade Wars or Protests in Hong Kong saw negative share price reactions while the offshore earners that demonstrated resilience and FX leverage were rewarded strongly.

Mix bag for growth names: While investors continued to reward growth names like Afterpay, Nanosonics and Wisetech, it wasn't a slam dunk across the space. We saw some previous market darlings like Nearmap and A2 Milk de-rate sharply when "promised" growth fell short of expectations.

What went well for us

- **Up-weighting positions where share prices had drifted lower**: We had a number of position which started to drift lower into the result given the lack of news flow (and to a lesser extent liquidity). We used this opportunity to add to our positions.
- **Capital management**: We saw numerous examples of companies with healthy balance sheets undertaking capital management. Capital management came in a number of forms including buybacks, special dividends and increased payout ratios.
- **Buying negative share price reactions**: Stocks such as Atomos and Johns Lyng Group and Rhipe had negative share price reactions when they reported. We re-examined our investment thesis on these names and re-reviewed the result, and determined that the market had misunderstood the business or was over reacting to potential stock overhangs. As such we saw the large share price moves as a buying opportunities which allowed us to add to our original positions.

What went poorly for us

- **Not owning enough healthcare**: Healthcare was the best performing sector in the ASX Small Ordinaries finishing up 1.1% for the month. The index was driven by names such as Polynovo, Nanosonics and Pro Medicus. Unfortunately, we were naked these names as their market caps were significantly too large for us to justify owning them in a micro-cap fund.

Overall, we are extremely pleased with how the portfolio performed through reporting season. The portfolio benefited from good old fashion stock-picking, with numerous positions delivering earnings upgrades and better than anticipated cashflow.

On stock specific news outside reporting season, one of our core positions (RuralCo) received ACCC and FIRB approval for its takeover by Nutrien. As a reminder we have been a fan of Ruralco at Ellerston for some time. The current management have done a great job growing and diversifying the business, while at the same time controlling costs to ensure the company is giving shareholders the correct return. Despite the fact the share price having not moved much during the past 3 years, the company had paid healthy dividends while giving us exposure to agriculture. RHL was a perfect fit for our GARP (Growth at a reasonable price) style. The business was undervalued on a relative (Elders traded at a large premium) and on absolute (cashflow valuation) basis, but offered earnings growth with increasing quality. RHL received a bid from Nutrien (Canadian player who bought Landmark in Australia previously) in February. This bid was at a 47% premium and has unlocked the value for shareholders in the company ($4.40 cash price plus 10c interim dividend, there is also a chance of a 90c special dividend with around 39c of franking credits). We continued to hold RHL believing the risk/reward on ACCC approval was in our favour. We are now going to collect our full takeover price as well as our dividend and franking credits. The implementation date for the deal is for the 30th of September.

Regards

David Keelan

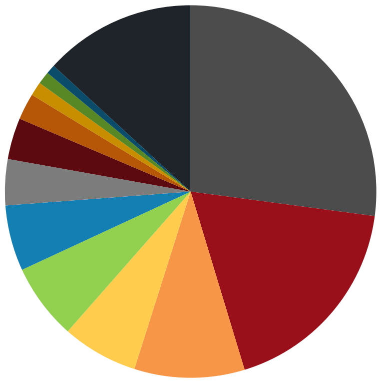
Alexandra Clarke

PORTFOLIO CHARACTERISTICS

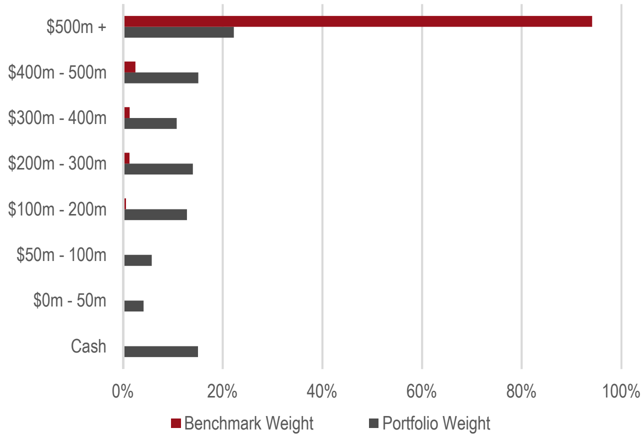
KEY PORTFOLIO METRICS

FY20e	Fund	Benchmark
Price/Earnings	17.5x	19.2x
Dividend Yield	1.5%	3.1%
Net Debt/EBITDA	0.0x	1.4x

SECTOR ALLOCATION



MARKET CAPITALISATION



All holding enquiries should be directed to our registrar, Link Market Services on 1800 992 149 or ellerston@linkmarketservices.com.au

Should investors have any questions or queries regarding the fund,
please contact our Investor Relations team on 02 9021 7797 or info@ellerstoncapital.com
or visit us at https://ellerstoncapital.com/

SYDNEY OFFICE
Level 11, 179 Elizabeth Street,
Sydney NSW 2000

MELBOURNE OFFICE
Level 4, 75-77 Flinders Lane,
Melbourne VIC, 3000